Hong Kong | Minerals, Industrial, Real Estate

Citic Pacific (0267 HK)

February 5, 2014

Citic Pacific

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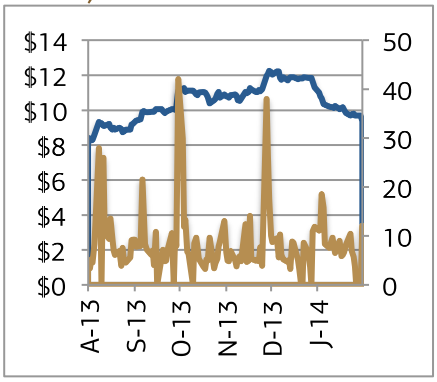
Citic Pacific (0267 HK) one-year share price in HKD (left axis, blue) and volume (right, gold, in mln shares)



Source: Yahoo Finance

Citic Pacific (0267 HK)

Price	HKD 9.45
Rating	**Sell**
J Target Price	**HKD 1.89**
Downside	**79%**
Market Cap	HK$34.49 bil
Turnover	7.6 mil
Free Float	42%

Source: Yahoo Finance Feb, 5 2014

Rowing without ores

+ Iron ore: it works only if ore is over USD 158

We do not see any scenario where the iron ore division can make a profit let alone repay debt. Cash cost is USD 91, while 2014 will see ore prices drop into the 80s. Delays in production have been persistent, such that the first shipment of finally went out at the end of 2013, ending 2013 with around 100,000 MT shipped instead of over 4 mln tons. The cause of the continued delays in production may be asbestos, which could see the mine closed as a safety hazard.

+ Special steel: profits down, not up as claimed

Citic Pacific's steel mills are still making losses. We believe that accounting irregularities are masking these losses.

+ Real estate: 60% down

The company delivered far fewer properties in 2013 and therefore sales fell 60% YoY. We question if presales are real or instead may constitute a form of structured financing.

+ Selling good assets to fund the bad

Another HKD 2.1 bln was raised from asset sales. There is only HKD 20 million left to sell, but these sales merely stave off company collapse.

+ Target price HKD 1.89

Based on our sum-of-the-parts valuation, our base case valuation of the company has a valuation of zero. We assign the higher price based on our view that Citic Group would likely take Citic Pacific private after a fall in value of 80%. History of Citic subsidiaries suggests that 80% is about the level at which the parent will intervene.

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Comedy of errors in iron ore

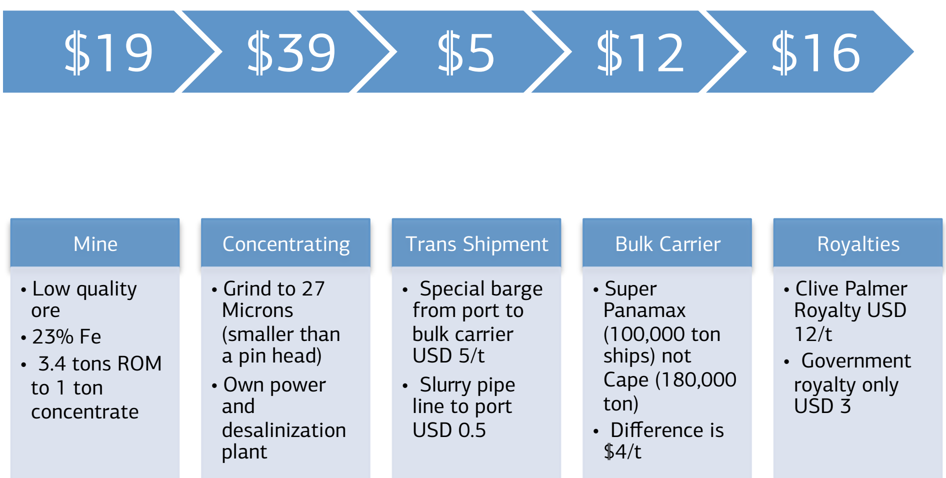
We do not believe that Citic Pacific's iron ore division will ever make money. Even if the mine were debt free and all assets written off, this low-quality mine would not be worth operating. We therefore see no potential for recovery of the investment in this operation.

The mine now has one production line in operation at 60% capacity. By the time all six lines are in operation in 2015, we expect the price of iron ore will be south of USD 85/ton and the mine unviable to operate. Additionally, the presence of asbestos in the mine may well see the mine shut down this year.

Nothing has gone right for the mine. Even the celebrated moment of the first shipment in December 2013 was a shambles. When the company turned on the loader for the first shipment to be loaded onto a barge, someone had forgotten to dock the barge. The first few thousand tons of iron ore were dumped into the ocean.

We had expected 4.75 MMT of iron ore to be produced in 2013; in the end, it was one 100,000 MT. We expect that, this year, the mine will produce 6.2 MMT. The COGS (CIF China not including depreciation) has fallen from USD 93 to USD 91, as the Australian dollar has fallen 10%. (See our initiation on Citic Pacific for details of the mine costs). We expect costs eventually to fall to around USD 80/ton as a result mainly of the fall in the AUD to USD 0.8 and a falling iron ore price reducing the royalties payable on price at a rate of 15%, with a small $1 improvement from capacity utilization of utilities.

Chart 1. Sino iron cost structure: USD 91/ton



Source: J Capital

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Table 1. Est Commissioning and Production Schedule

Production Lines	Commissioned	Capacity	Utili.	2014	2015	2016	2017
Production Line 1 Capacity 4 MMTPA	Dec 13	4.00	85%	3.4	3.4	3.4	3.4
Production Line 2 Capacity 4 MMTPA	Jul-14	4.00	85%	2.8	3.4	3.4	3.4
Production Lines 3 - 6 Capacity	Jan-15	12.00	85%		10.2	10.2	10.2
Production		MMT		6.2	17.0	17.0	17.0

Table 2. Exchange Rate and Iron Ore Price Scenario: Impact on Contribution Margin

AUD/USD	COGS USD/T	Contribution Margin USD/Ton							
0.9	87.3	52	42	31	19	15	10	4	-1
0.85	84.9	54	44	33	21	17	12	6	1
0.8	81.1	58	48	37	25	21	16	10	5
0.75	77.2	62	52	41	29	25	20	14	9
	Spot 62% Fe	130	120	110	100	95	90	85	80
	CP Price 66% Fe	139	128	117	105	101	96	90	85

Source: J Capital

Operating costs of USD 91/ton

Given that the mine has USD 12/ton of admin and maintenance capex, positive cash flow is possible only with iron ore prices above USD 90/ton. However iron ore prices need to remain above USD 120 beyond 2014 in order to service the debt, and, in order to make a profit and meet the cost of depreciation, the iron ore price needs to be above USD 158.

We have modeled iron ore prices averaging USD 110/ton in 2014 and the AUD at USD 0.85. In 2014, the mine production will be around 40% of capacity with construction capex at around USD 650 mln. In 2015, when the mine is at capacity and there is no construction capex, we have modeled iron ore at USD 90/ton and the exchange rate at USD 0.8. Those assumptions mean the mine could not pay the interest on loans.

We expect that the mine will be closed in 2015 and the debt of around USD 10-12 bln will be written off.

The asbestos overhang

We believe the 12-month delay from commissioning of equipment to production in 2013 was due not only to mechanical problems, as claimed by the company, but also to the presence of asbestos in the iron ore. In 2009, asbestos was found in the mine. The mine was closed and was not opened until stringent safety measures were put into place. Asbestos is present in most iron ore deposits in the Pilbara, however, CITIC Pacific is the only mine

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that is processing magnetite. The other mines are simply crushing hematite. Processing magnetite magnifies the asbestos problem, as the fibers are more likely to become airborne.

The Western Australian Environmental Protection Authority chairman Paul Vogel said in June 2013 the agency was mounting a major effort to develop a plan to deal with the asbestos problem, which he said was far worse at Cape Preston, the location of CITIC Pacific's mine, than anywhere else in the Pilbara.

"We are working with the Department of State Development, the Department of Health, Department of Mines and Petroleum and the Office of the EPA at a very senior level, " he said

To enable Citic Pacific to service debt, ore prices would have to remain over USD 120, but to accommodate depreciation, prices would have to be USD 158—which will not be seen again in a decade.

"I am confident we will find a way forward, but this is something on a scale we haven't managed before. [W]e will need to understand what the risks are through the whole life cycle for production of magnetite ore at that location.

We spoke with a mining engineer, who said asbestos does not pose a problem if it remains wet. If it is dry and airborne then it is a threat to human health.

A spokesperson for the CFMEU, the union that represents the mine workers at the CITIC Pacific mine, said yesterday that they had written three letters to the relevant government authority warning of the dangers of asbestos at the mine. He said the mine is full of asbestos and that miners only wear masks when working on the concentrators and not asbestos-protective clothing. The potential for dust on their clothes and body to be inhaled after or during a work shift is high. The CFMEU official is so concerned about the danger that he refused to meet the company onsite.

There is a strong potential that the mine will be closed by the WA government due to the safety concerns over asbestos in the beneficiation process this year.

Weak steel

We believe that the company's reported steel-division results have been manipulated: we think the steel division made losses in 2013 and 2012 rather than the HKD 221 mln in profit claimed in FY 2012 and HKD 967 mln in H1 2013. The losses were disguised, we believe, through related-party transactions. Given the Byzantine structure of the steel division, with three major companies, buried under six layers of ownership and with at least 24 related parties, such accounting tricks are simple to pull off.

CITIC Pacific reported in its 2013 Interim report that:

> "Underlying operating contribution [of the steel division] for the first half of 2013 was at a similar level as for the same period as last year. Despite the overall price of our products being down 10% for the first

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> half compared to last year, margin improved resulting from the lower cost of major raw materials utilized in production. A total of 3.6 million tons of finished steel products were sold during the reporting period 3% more than last year."

We do not believe any of that statement.

- First, the price of special steel fell 20% in 1H 2013, not 10% as the company claims. We checked special steel billet prices in the region of the company's steel plants and cross checked that pricing information with the Jiangyin Xingcheng Special Steel price information in its debt prospectus published in May 2013.

- Second, steel production reported to the Chinese steel association, CISA, by Citic Pacific was up 11% YoY and not 3% as claimed in the company report. Additionally Citic Pacific's own claim is at odds with its reported steel sales of 3.87 MMT in H1 2012 statement, which would make H1 2013 a decline of 7%.

- Finally, when we reviewed the financial reports (published quarterly as a requirement of the RMB bonds the company has issued) by subsidiaries Xingcheng and Hubei Xinye Special Steel, margin went up by 1% and not the 2% reported by CITIC Pacific. Our own estimate based on the steel produced and the changes in prices indicated margin would have gone down 4% and hence profit would have gone down 99%.

Citic Pacific uses a maze of related companies to stuff costs into unseen pockets.

Table 3. Steel, Iron Ore and Coke Pricing Data

	2012	2013	1H 2012	1H 2013
Iron Ore USD/Ton	130	135	142	137
		4%		-4%
Coke RMB/Ton	1,790	1,456	1,998	1,547
		-19%		-23%
Special Steel: Billet RMB/Ton	4,938	3,824	4,938	3,914
		-23%		-21%

Table 4. Citic Pacific Steel Division Steel Production

MMT	1H 2012	1H 2013	2012	2013
Steel Production (reported to CISA)	3.39	3.76	6.62	7.65
Growth		11%		16%
Steel Production Reported by CP	3.87	3.60		
Calculated Growth		-7%		
Reported Growth		3%		

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Table 5. Citic Pacific Steel Division Growth

	Growth Reported	Growth of Subsidiaries	J Cap Model
	1H 2013	1H 2013	1H 2013
Revenue	-8%	-14%	-12%
Costs	-10%	-15%	-2%
Change in Margin	2%	1%	-4%
Profit	32%	16%	-99%

Table 6. Citic Pacific Steel Division Gross Profits

HKD Mln	1H 2012	2012	1H 2013
Citic Pacific Gross Profit (consolidated)	819	735	1083
Citic Pacific subsidiary Gross Profit (consolidated)	598	662	695
Variance	221	73	388

Financial reports of subsidiaries conflict with those of the parent.

The performance of the subsidiary steel companies is not only lower than that reported by Citic Pacific Group but also appears to be fraudulent.

Xinye had an operating loss of HKD 110 mln in 2012 and YTD Q3 2013, an operating loss of HKD1 3.8 mln. Net profits, however, were HKD 10.7 mln and HKD 6.5 mln, because of government subsidies of HKD 65 mln and 45 mln respectively.

However, we find suspicious that, from Q1 2013 through Q2 2013 other receivables fell from RMB 3.7 bln to RMB 1.7 bln, and other payables fell from RMB 2.7 bln to RMB 0.7 bln. We know from previous research that these two items are almost entirely sales and purchase transactions with related parties. Related-party sales were 50% of sales for Xinye in 2012, and purchases were 15% of costs in the same period. We suspected that these were not real sales and were just accounting entries to generate sales. The fact that both items went down by the same large amount in a short period of time indicates to us that they were just accounting entries to be canceled out.

Xingcheng, which appears to be doing better than its sister company, has accounts that do not add up. Cash flow from operations end of Q1 to end of Q3 improved by RMB 1.645 bln largely because receipts were greater than revenue and payments were less than costs, but accounts payable went down, not up, and accounts receivable did not match the excess of revenue over receipts. The cash balance only matches with the balance sheet because of an unusual new asset: Xingcheng made an entrusted loan of RMB 500 mln in the period to a paper company: Jiangyin Xingcheng Hejin, which is a direct subsidiary of CITIC Pacific collocated with Xingcheng and sharing the same

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legal person. Xingcheng Hejin registered capital is only RMB 91 mln and therefore it would not be legal for it to have a loan of RMB 500 mln.

If you believe in arithmetic, you will not buy CP's reports. One entrusted loan of RMB 500 mln probably is a fiction.

We believe that Xingcheng has inflated its sales and operating cash flow in order to maintain a high credit rating for its bonds. When Xingcheng issued its RMB 500 mln bond, in May 2013, it announced it would use the funds to reduce bank loans by RMB 200 million and augment operating cash with RMB 300 million. At no time was an entrusted loan to a related party given as a reason for the issue of a bond, nor does Citic Pacific make a mention of significant investment in Xingcheng Hejin. We believe the entrusted loan is a vehicle for removing cash from the balance sheet to pass audit. If that is the case then we also believe Xincheng is loss making.

CITIC Pacific inflated H1 2013 profits by HKD 324 mln (7% of net profits) by claiming negative goodwill on the acquisition of 25% of a new production line it did not own at Xingcheng. This was deftly obscured in the Interim Report 2013 and in the HKSE announcement of the acquisition in March 2013. They paid less for the asset because it is worth less given the current steel market environment. We do not believe there is a basis for booking negative goodwill.

Real slow

Mainland property sales were down 60% YoY in H1 2013. Company guidance is that property will continue to underperform this year, as few properties will be delivered. The company claims good cash flow from presales of HKD 1,098 mln compared with HKD 218 mln in sales. We checked the key Shanghai development and confirmed that presales have been strong. However, the occupancy level of the development appears low, and we question the presales. We also checked pricing and sales of CITIC's largest residential project in Hainan and found sales slow and discounts high. As a result, we have reduced the price and sales forecast for the Shenzhou Penisula project.

We are skeptical of the property sales reported and have reduced our forecast for the Shenzhou Peninsula.

CITIC Pacific made its best money in real estate from commercial property in Shanghai. Subsequent sales are from lower-quality residential real estate in suburban Shanghai and Hainan Island. The property assets are less than half of the debt of the iron ore division. Property will not save the company.

Not much left

Citic Pacific's other businesses are solid businesses, and, with the exception of the trading business Dah Hong Chong, are doing well. Citic has been slowly milking these businesses by selling down assets or wholesale divestiture. Citic has described their sale of these good assets as "focusing" on their core business. We see it more as desperate attempt to raise capital to keep the group solvent. In 2013 the company raised HKD $2,184 mln from the sale of real estate assets owned by Dah Hong Chong. The company has raised a total

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of HK $21.6 bln from asset sales since it started construction on the iron ore mine. The remaining other business, currently contributing 100% of profit. If CITIC Pacific sold all its interest in the other companies then it could potential raise HKD 20 bln at best. This is only 25% of the iron ore division's debt. Further asset sales can only delay the inevitable.

Other assets perform well, but Citic is using them as a kitty to cover losses elsewhere, and the kitty is drying up.

The energy division is outperforming our expectations, and we have revised up our estimate of earnings, increasing valuation of that segment from HKD 2.76 to 2.85 per share. Dah Hong Chong valuation has halved to HKD 1.24 per share as it lost the Bentley dealership in mainland China, other trading business was down, and it divested assets. The telecom division improved performance and valuation increased from HKD 0.76 per share to 0.87.

Table 7. Proceeds from Asset Sales

HKD Millions	2009	2010	2011	2012	2013
Asset Sales	8,500	7,385	5,381	4,118	2,184

Source: Company Reports

Table 8. Other Assets Value

Other Assets	Enterprise Value
Dah Chong Hong (1828 HK)	4,540
Energy	10,409
Telecom	3168
Tunnel	3086
Total	21,185

Source: J Capital

Catalysts

The iron ore price will drive the value of this stock. With the mine now producing, the under performance of the iron ore division will be acutely apparent. As volumes are low and construction is not complete, the company may be able to hide performance for another six month, but iron ore prices below USD 90/ton will be the end of CITIC Pacific.

The poor performance of the steel mill and real estate business and the diminishing number of "other business" that can be sold will make it difficult to continue to hide the poor performance of the iron ore division.

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Valuation method

Our base case scenario produces a negative valuation for the company. This valuation is arrived at using a sum of the parts approach. Our base case scenario is long-term iron ore price at $85/ton, with iron ore at $110/ton in 2014 and $90/ton in 2015.

Table 9. Sum of the Parts Valuation

Business	Valuation Method	Enterprise Value	Net Debt	Equity Value	Value Per Share
Steel Manufacturing	DCF	34,311	10,882	23,429	6.4
Iron Ore Mining+ships	DCF	-7,868	83,813	-91,680	-25.1
Property	DCF	35,278	-7,865	43,143	11.8
Transport infrastructure	DCF	3,086	-1,113	4,199	1.2
Energy	PB			10,410	2.9
DCH - Trading	Market Cap.			4,540	1.2
Other Investment	BV			3,508	0.96
Total Value				-2,452	-0.7
Conglomerate discount 20%				-1,962	
Price Target					**-0.5**

Source: J Capital

Risks

The Chinese government continues to stimulate the economy and this may indirectly help the property, steel and iron business of Citic Pacific, helping to sustain the stock price at current levels.

CITIC Group may choose to purchase the iron ore, or another business from the group to remove the problem from Citic Pacific operations. We consider this unlikely, but SOE parent companies have made such transactions to rescue listed subsidiaries. The most recent was a RMB44 billion purchase of Bao steel's poor stainless steel business at an above book price, for what was essentially a bankrupt business.

CITIC Group may choose to take Citic Pacific private. When the company faced trading losses in late 2008 CITIC Group let the stock price fall 80% before it stepped in with an equity injection to save the company. We would expect CITIC Group would similarly wait for the share price to fall at least 50% before it will step in and take the company private at a cost of around USD $1 billion.

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The Chinese government may directly subsidize Citic Pacific's operations. In the recent years subsidies to listed companies in China have been increasing, including subsidies that saves companies from bankruptcy. Citic Pacific's level of debt and poor operations would make this a very large sum in the order of RMB80 billion and we do not think the group could attract a subsidy of that level.

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