China | Minerals, Industrial, Real Estate

Citic Pacific (267 HK)

June 12, 2014

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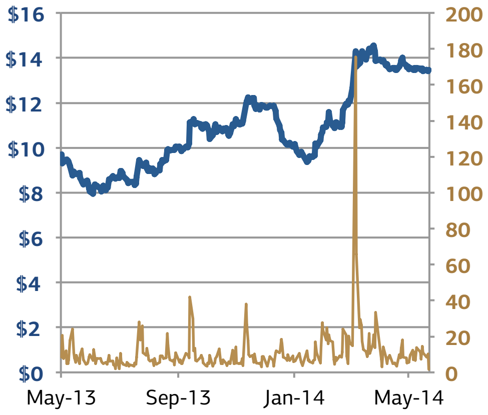
Prepare ye the way of a write-down

Citic Pacific (267 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, June 12, 2014

Citic Pacific (267 HK)

Price	HKD 13.40
Rating	**No rating**
Price target	**No target**
Difference	**—**
Market Cap	HKD 48.9 bln
Simple Moving Avg.	9.24 mln
P/E	8.87x

Source: Bloomberg, June 12, 2014

+ Citic Ltd. asset injection HKD 286 bln

We expect Citic Pacific will write-down up to HKD 90 bln in assets when it closes its iron ore mine post the "acquisition" of Citic Ltd. The HKD 286 bln asset injection will allow Citic Pacific to survive that event.

+ Citic Group to own 82% post acquisition

SOEs have been forced into putting new cash into Citic Pacific and will own 9% of the company after the acquisition. They will share the pain of the write-down. The real free float will be 9% of the company, with liquidity up around 50%.

+ Iron ore mine is cash flow negative at USD 95 per ton

Even if they can get the mine to full capacity, it will be cash flow negative at current iron ore prices.

+ Closing coverage: no rating

Lack of transparency, large size and diversity make it difficult to credibly cover this stock. We do believe there will be an asset write-down of between HKD 1.22 - 3.71 per share some time in 2015, when Citic Pacific closes its iron ore mine.

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Asset injection before the deluge

The HKD 286 bln asset injection will enable Citic Pacific to survive the closing of its iron mine.

The merger of Citic Ltd. into Citic Pacific (267 HK) has bizarrely been hailed as an example of SOE reform. In reality, the injection of Citic Ltd. into Citic Pacific is a preemptive move to shore up Citic Pacific's balance sheet before it closes its iron ore mine and writes down the associated debt. Closing down the mine and writing down the HKD 90 bln in assets would have spelled the end of Citic Pacific absent the asset injection. But with the additional HKD 286 bln of assets injected into it, Citic Pacific will survive the event. As it is, the company will be able to write off the assets some time in 2015.

We expect the write-down to be in the range of HKD 30 to 90 bln, which represents 9–27% of the post market capitalization.

What is Citic Limited?

87% pf Citic Ltd. profits from financial services.

Basically it is a bank. A bank servicing corporations and saddled with underperforming and risky resource and real estate assets. The company mirrors the Chinese economy, it has a range of businesses but the only thing that makes money is finance. Financial services make up 87% of profits, of which 88% come from its 67% ownership of CITIC Bank (998 HK) and 12% from its 20% ownership of Citic Securities (6030 HK).

CITIC Bank derives most of its profit from providing financial services to corporates. The Real Estate and Infrastructure division of CITIC has real estate revenue 10x that of Citic Pacific and makes half of its profits from infrastructure assets, which are, mainly, toll roads and oil terminals.

The resources and energy division accounts for 27% of revenues and makes a loss. The resources and energy division comprises mainly Citic Resources (1205 HK), but also unlisted resource assets. Most of the resources revenue comes from commodity trading and mining and processing alumina and coal. Some of the worst performing sectors in resources.

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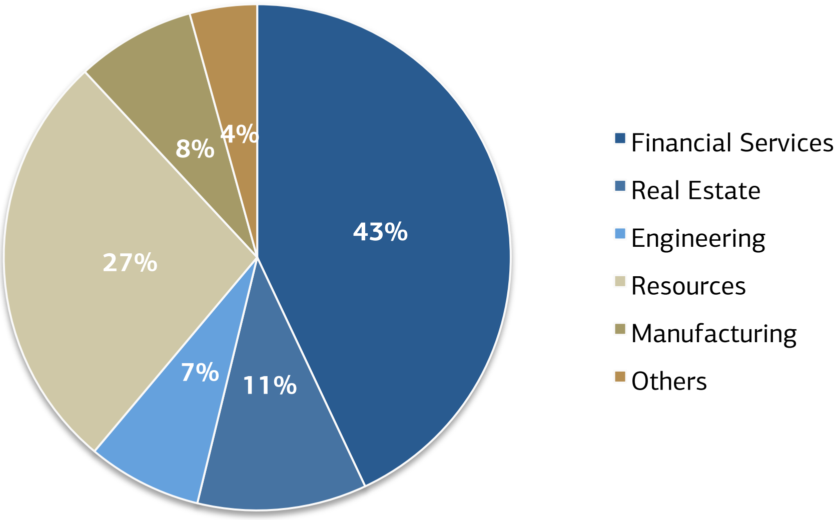
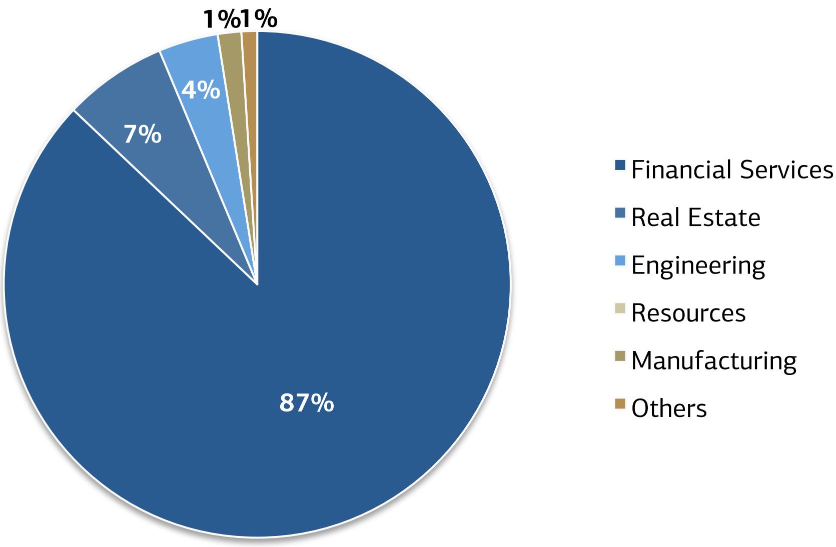
Chart 1. Citic Ltd. 2013 revenue share by division



Source: Company reports, J Capital Research

Chart 2. Citic Ltd. 2013 profit by division



Source: Company reports, J Capital Research

Acquisition structure

Citic Group currently owns 58% of Citic Pacific. Citic Pacific will pay Citic Group RMB 227 mln, of which 14% will be in cash from an equity raise, and 86% by issuing new shares to Citic Group. Of the cash raised for the acquisition, 80% came from SOE purchases in the capital raise. Post acquisition, Citic Group ownership will rise to

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82% (75% according to an earlier announcement). The free float will be 18%, just about the minimum 15% specially approved by the Hong Kong Exchange. Half of the free float will be held by SOEs that were almost certainly forced to buy into the new company and will not be trading their shares. Effectively the free float is reduced to 9%, and the new liquidity for the stock will increase by around 50%.

Free float in reality 9%.

Table 1. Citic Group ownership pre and post acquisition

	RMB	Shares	Ownership
Pre acquisition			
Citic Group shares		2,098,736,285	58%
Free float		1,550,707,875	42%
Total shares		3,649,444,160	
Announced acquisition plan			
Total consideration	227,000,000,000	21,253,879,470	
Cash consideration	50,000,000,000	4,675,123,032	
Share consideration	177,000,000,000	16,578,756,438	
Citic Group shares post		18,677,492,723	75%
Free Float		*6,225,830,907*	25%
Total shares on issue post		24,903,323,630	
Expected post acquisition			
Cash consideration	31,203,540,055	2,935,798,000	
Share consideration	195,796,459,945	18,339,332,321	
Citic Group shares post		20,438,068,606	82%
Free float total		4,486,505,875	18%
Free float held by SOEs		2,348,638,400	9%
Free float other		*2,137,867,475*	9%
Total shares post		24,924,574,481	

Source: Company reports, J Capital Research

New ownership

The published list of investors in the capital raise reads like a

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SOEs will contribute 80% of the cash raised from the issuing of new shares, but will share the losses.

seating arrangement for a dinner party, instead of boy-girl it alternates SOE-private company. The SOEs bring more to the party, stumping up 80% of the cash raised from the issuing of new shares. You can imagine the directive being issued by the State-owned Assets Supervision and Administration Commission (SASAC) to the SOEs, ordering them to participate in the equity raise and them all wincing at the prospect of having to share the cost of CITIC's failed iron ore mine.

Table 2. Participants in Citic Pacific share subscription | May 14, 2014

Ownership	Ultimate owner	Notes	% of new issue
Private	AIA Company		6%
Private	Qatar Holdings LLC	Qatar's soveriegn wealth fund	4%
Private	CTBC Life Insurance	Taiwanese insurance company	2%
Private	Tokio Marine & Nichido	Japanese insurance company	2%
Private	Mizuho Bank	Japanese private bank	2%
Private	Temasek Holdings	Singapore's sovereign wealth fund	2%
Private	Fubon Life Insurance	Taiwanese insurance company	2%
SOE	National Social Security Fund	China SOE pension fund with RMB 1 tln under management	42%
SOE	State Administration of Foreign Exchange	Soveriegn wealth fund with USD 3.2 tln under management	12%
SOE	China Life Insurance Company	Chinese SOE insurance company	10%
SOE	Bank of China	Chinese SOE bank	5%
SOE	Agricultural Bank of China	Chinese SOE bank	4%
SOE	China Construction Bank	Chinese SOE bank	3%
SOE	ICBC	Chinese SOE bank	3%
SOE	SASAC	SOE operator of Beijing Subway	2%
Total			100%
SOE total			80%
Private total			**20%**

Source: Company announcement, J Capital Research

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Why are they saying they are doing the acquisition?

Key reasons give are:

- *The company considers it a great opportunity to get size and scale to be the largest multi-industry conglomerate in China.* However, only one of Citic's businesses is a market leader, CITIC Securities, and its ownership level is only 20%.
- *It has a sustained strong financial performance.* But the net profit CAGR is only 4% for the last 3 years when the economy has been growing at a CAGR greater than 10.5%.
- *Improving profitability demonstrated by the per share profitability of the combined would have been 29% more per share in profit for 2013.* Given that many parts of Citic Limited were unlisted we will just have to trust them on this issue.
- *Improved credit ratings enabling lower cost debt.*

What's the reason for the acquisition? Fine print: to pay for the iron ore mine

What we believe is the key reason is buried in the *Circular for Acquisition of Citic Ltd* ("Circular") under the section heading "Profit pressure on the Group," where the woes of the iron ore mine are again laid out and the following statement about the iron ore mine is made:

"Citic Pacific may also face impairment pressure."

Just one line, but that is the whole reason for the acquisition.

Rising Risk: more complex, less transparent, poor sectors

Citic Pacific is a difficult company to cover, as disclosure on the group's key divisions is very poor. To date, the costs of the iron ore mine have not been released. The steel business is discussed in vague, high-level terms. The real estate business is geographically dispersed and only limited information has been released. When we do primary research and compare publicly released data of divisions in Chinese, we find significant discrepancies with the reported performance of the division. With the acquisition of Citic Ltd. this complexity will be increased by a factor of 10x. The Circular's detail on the unlisted divisions of Citic Ltd. are woefully light on detail for such a large acquisition.

What is clear is that the key sectors that Citic Ltd. operates in, such as real estate and resources, are already in deep trouble. Financial

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services have performed relatively better, however, our outlook for that sector is negative, and we believe Citic Ltd. profits from financial services have already peaked. After the acquisition, it will become a bigger group but with more risk and lower profit.

Iron ore loses money at USD 95 per ton

Hard to imagine Citic Pacific's iron ore division making money.

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. At the current price, even operating at full capacity, the mine would make a cash flow loss of USD 6 per ton.

Table 3. Cash operating costs and price

Items/assumptions	USD/ton
Exchange rate USD/AUD	0.9
Cash COGS, C1 costs	58
Shipping cost per ton USD	17
Palmer royalty A + B	9
Government royalty	3
Total unit costs	86
Maintenance capex	10
Finance expense*	11
Total all in cash costs	**107**
62% Fe Iron ore price per ton	95
66% Fe Iron ore price per ton	101
Cash flow per ton	**-6**

Source: J Capital Research,

* Finance costs is divisional debt servicing cost at full capacity, if it were total debt at current capacity then the finance cost per ton would be USD 117 (divisional debt at current capacity would be USD 42/ton)

Total cost per ton will fall by USD 5 when it achieves full capacity in 2015. By that time we expect the price of iron ore will be south of USD 85/ton and the mine unviable to operate. Even with the divisional debt written down to zero cash operating margin would still be negative.

Iron ore price needs to be above USD 158 in order for the iron ore division to make a profit.

We estimate in order for the iron ore division to make a profit and meet the cost of interest and depreciation, the iron ore price needs to be above USD 158.

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Table 4. Iron ore division debt

	HKD mln	HKD cost per share	Value at 13.48
Direct iron ore division debt	30,379	1.22	*9%*
Related corporate debt	62,000	2.49	
Total debt	92,379	3.71	27%
Total market value post acquisition	335,983		

Source: Company reports, J Capital Research

We expect that the mine will be closed in 2015. Citic Pacific may choose to write-down the debt of the division, or the total assets/debt of the division. We estimate the write-down will be between HKD 30 and 90 bln. This represents between 9% and 27% of the market capitalization of the group post acquisition.

Closing Coverage

We are closing out coverage of Citic Pacific and have no recommendation or price target for the company.

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