

J.P.Morgan

Asia Pacific Equity Research

18 August 2014

Zhaojin Mining Industry (1818 HK)

Neutral

Price: HK\$5.11

15 Aug 2014

Price Target: HK\$5.00

PT End Date: 31 Dec 2015

First-take 1H14 results - Beat, high financial leverage as overhang

Zhaojin posted stronger-than-expected 1H14 net profit of RMB324m (+8% y/y), with production and (lower) cost exceeding our expectation. As with Zijin, we expect Zhaojin to mark an earnings trough in 2014, but its weak balance sheet and strong reliance on short-term debts remain a concern. Stay N rated – Zijin remains our preferred gold exposure in China.

Table 1: Zhaojin Mining's quarterly financial summary

(RMB Mills)	1Q13	2Q13	1H13	3Q13	4Q13	2H13	2013	1Q14	2Q14	1H14	QoQ 2Q14	YoY% 2Q14	HoH% 1H14	YoY% 1H14
Revenue	1,164	1,207	2,371	1,288	2,685	3,973	6,344	1,091	1,755	2,845	61%	45%	-28%	20%
Cost of sales	(485)	(844)	(1,329)	(487)	(2,288)	(2,774)	(4,104)	(510)	(1,306)	(1,815)	156%	55%	-35%	37%
Gross profit	679	363	1,042	801	398	1,199	2,240	581	449	1,030	-23%	24%	-14%	-1%
Net operating profit	355	45	399	376	198	574	973	204	180	384	-12%	301%	-33%	-4%
Net profit	234	66	300	203	232	434	734	143	182	324	27%	176%	-25%	8%
Margin														
Gross profit	58%	30%	44%	62%	15%	30%	35%	53%	26%	36%	-28pps	-5pps	6pps	-8pps
Operating profit	30%	4%	17%	29%	7%	14%	15%	19%	10%	13%	-8pps	7pps	-1pps	-3pps
Net margin	20%	5%	13%	16%	9%	11%	12%	13%	10%	11%	-3pps	5pps	0pps	-1pps
Tax rate	24%	-3%	21%	32%	14%	24%	23%	30%	18%	24%	-13pps	21pps	0pps	3pps
Net gearing	61%	90%	90%	79%	96%	96%	96%	58%	94%	94%	35pps	3pps	-3pps	3pps
Cash flow (Rmb M)														
Operating cash flow	(271)	308	37	261	577	837	875	100	485	585	386%	57%	-30%	1479%
Investment cash flow	(1,011)	(890)	(1,901)	(1,534)	(1,006)	(2,541)	(4,442)	(428)	(695)	(1,123)	62%	-22%	-56%	-41%
Capex	(414)	(742)	(1,156)	(337)	(1,804)	(2,141)	(3,297)	(467)	(538)	(1,005)	15%	-28%	-53%	-13%
Free cash flow	(685)	(434)	(1,119)	(76)	(1,227)	(1,304)	(2,423)	(367)	(53)	(420)	-86%	-88%	-68%	-62%

Source: Company data, J.P. Morgan estimates

Key Highlights

- 1H14 results beat.** Zhaojin reported 1H14 net profit of RMB324m (+8% y/y), 8% ahead of JPMe (RMB301m). Key drivers of the earnings surprises related to stronger-than-expected operating performance, with both production and (lower) costs exceeding our expectations. The company produced 9.7 tonnes of mined gold (+13% y/y), while unit gold cost improved to RMB134/g (-0.6% y/y), ahead of JPMe +1%. Lower effective tax rate also helped the bottom line.
- Weak balance sheet raises fundraising risk.** Zhaojin's deteriorating balance sheet strength is a concern, with negative FCF pushing net gearing (ND/E) higher to 94% (from 1Q14: 76%). The company remains highly reliant on short-term debts, which accounted for 64% of its total debts. Notably, it has a corporate bond (RMB1.5bn) redeemable by bondholders from 23 December 2014, which may add to its fundraising needs.
- 1H14 operating performance ahead of its guidance.** Zhaojin did not provided specific guidance for 2H14, but its 1H14 performance are tracking better than its full-year guidance. As a refresher, it has set out 2014 production targets of 16.7 tonnes for mined gold (+10% y/y) and 9.4 tonnes of tolling gold (+8% y/y), while keeping unit cost increase no more than 5%. This compared with actual outputs of 9.7 tonnes and 5.3 tonnes, respectively, and unit cost decline of 0.6% in 1H14.

Impact

- We expect the market to respond positively to Zhaojin's strong operating performance.

Investor briefing

Zhaojin will host a small group investor briefing at its HK office. Full details below:

Date: 19 August 2014 (Tuesday)

Time: 3:30 p.m. – 4:30 p.m. (registration at 3:20 p.m.)

Venue: Room 1701, Infinitus Plaza, 199 Des Voeux Road Central, Sheung Wan, Hong Kong

Language: Mandarin

Investment Thesis

Zhaojin is China's fourth-largest gold miner, based primarily in Shandong. Its portfolio provides powerful leverage to gold prices, but this is muted under our benign outlook for gold. Still, we forecast earnings to trough in 2014 with a 2014-16 CAGR of 3%. That said, elevated debt levels and rising production from higher cost, ex-Shandong mines expose some risks. Stay Neutral rated with a Dec-15 PT of HK\$5.00.

Valuation

Our Dec-15 price target for Zhaojin of HK\$5.0 equates to 1.3x P/BV, 10.4x EV/EBITDA and 2.2% dividend yield for a 7% ROE, based on our FY14 estimates. Our PT is based on a blended average of: 1) PB-ROE valuation, EV/EBITDA multiple, P/E multiple, DCF-based NPV, and EV/reserve method.

Risks to Rating and Price Target

Upside risks

- Stronger-than-expected gold prices
- Better-than-expected cost control
- Higher-than-expected production growth

Downside risks

- Weaker-than-expected gold prices
- Higher-than-expected cost pressure
- Slower-than-expected production growth
- Worse-than-expected working capital control
- Higher-than-expected capex requirement

Asia Metals and Mining

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Other Companies Discussed in This Report (all prices in this report as of market close on 15 August 2014)

Zijin Mining Group (2899.HK/HK\$2.14/Overweight)

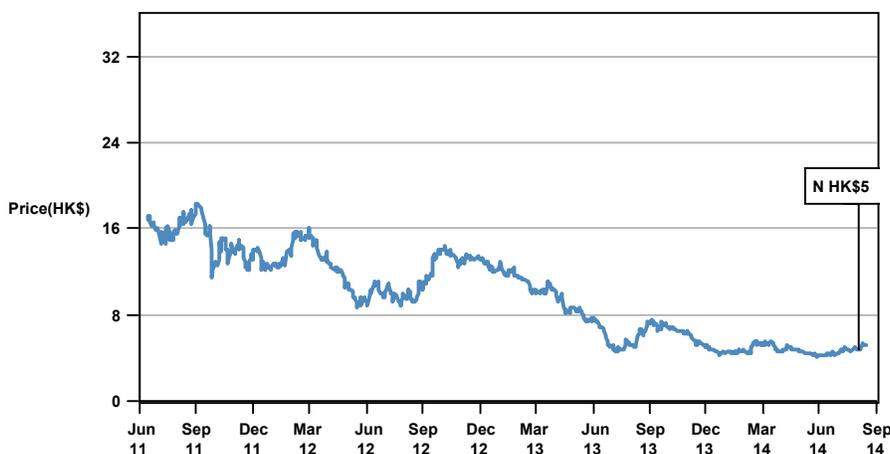
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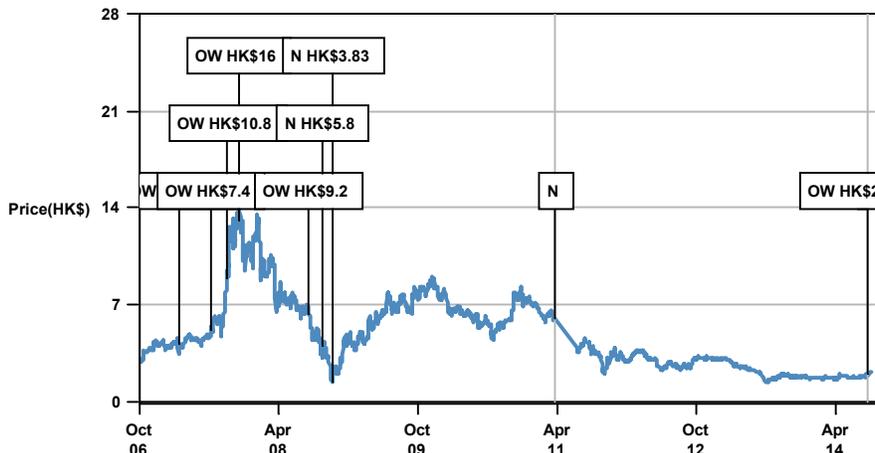
Zhaojin Mining Industry (1818.HK, 1818 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
03-Aug-14	N	4.80	5.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Aug 03, 2014.

Zijin Mining Group (2899.HK, 2899 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
10-Mar-07	OW	4.12	6.04
11-Jul-07	OW	5.10	7.40
10-Sep-07	OW	8.84	10.80
29-Oct-07	OW	13.04	16.00
30-Jul-08	OW	6.32	9.20
19-Sep-08	N	4.04	5.80
25-Oct-08	N	1.42	3.83
22-Mar-11	N	6.07	--
03-Aug-14	OW	1.96	2.45

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Break in coverage Mar 22, 2011 - Aug 03, 2014.

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Coverage Universe: Li, Waiyin Karen: Zhaojin Mining Industry (1818.HK), Zijin Mining Group (2899.HK)

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*Percentage of investment banking clients in each rating category.

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