

Zijin Mining Group

Out-of-control cost inflation

- We turn negative on Zijin Mining, mainly because there is no relief from cost pressures.
- Zijin's management guided limited cost reduction for the remainder of 2013, after a 44% cost increase for both gold and copper production in 1Q13.
- We raise our gold and copper cost assumptions, and cut our 2013/14 earnings forecasts by 35%/41% to RMB 2.58bn/2.64bn. Our forecasts are now 41%/37% below consensus.
- We downgrade Zijin to Underperform from Outperform and lower our price target to HKD 1.70 (from HKD 2.69). The stock trades at 13.9x 2013E and 13.4x 2014E PER, higher than its 2011-12 average of 12x and Zhaojin's 11x 2013E.

Major cost disappointment: We raise our 2013-15 gold and copper cost assumptions by 16-34%; actual 1Q13 costs were higher than our expectations, and management guided limited room for cost reductions even with a rise in production volume in the next few quarters. The cut-off grade at Zijinshan gold mine continues to fall and the cost savings momentum at Norton Gold Field is progressing slowly. We now forecast RMB 155/g (USD 777/oz) gold production cost for 2013, up 28%, after a 40% increase in 2012.

Prices fall in 2Q but costs remain high: Zijin increasingly feels the pain of cost inflation in 2Q13, when gold/copper prices corrected by 11%/8% from 1Q13 and costs remain high. Management guided that costs are unlikely to drop substantially, even with the commencement of new gold mines in Inner Mongolia, Gansu and Guizhou, as well as production ramp-up from Duobaoshan and Zijinshan copper mines.

50% drop in earnings; deteriorating ROE: We forecast a 12% drop in the gold price in 2013 but Zijin's earnings could drop by 50% based on our estimates. We cut 2013/14E net profit by 35%/41% to RMB 2.58bn/2.64bn, 41%/37% below consensus forecasts. Average ROE could be 9% in 2013-15E, less than half of the average level of 23% over 2009-12.

Valuation: Zijin trades at 13.9x 2013E and 13.4x 2014E PER, at the high end of its 2011-12 range of 10-14x. There could be c.30% downside if the stock goes back to 10x PER. We cut our price target to HKD 1.70, based on 0.7x P/NPV (from 1.0x), vs. 0.8x for global peers average. Zijin's PBR has corrected to 1.3x, near the record low; however, ROE is also at an all-time low and PBR could go lower from here.

UNDERPERFORM (from OUTPERFORM)

PRICE as of 6 Jun 2013

PRICE TARGET

HKD 2.09

HKD 1.70

Bloomberg code

2899 HK

Reuters code

2899.HK

Market cap

HKD 45,587mn (USD 5,873mn)

12-month range

HKD 2.03 - 3.30

EPS adj. est. change	2013E	-35.3%	2014E	-40.5%
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Year-end: December	2012	2013E	2014E	2015E
Sales (RMB mn)	47,874	46,515	48,788	49,979
EBITDA (RMB mn)	10,438	7,177	8,073	8,724
EBIT (RMB mn)	9,118	5,256	5,598	5,807
Pre-tax profit (RMB mn)	8,557	4,183	4,280	4,495
Net profit adj. (RMB mn)	5,212	2,580	2,640	2,773
FCF (RMB mn)	(3,411)	(86)	980	1,767
EPS adj. (RMB)	0.24	0.12	0.12	0.13
DPS (RMB)	0.06	0.03	0.03	0.03
Book value/share (RMB)	1.30	1.26	1.32	1.36
EPS growth adj. (%)	-8.8	-50.5	2.3	5.0
DPS growth (%)	-40.3	-50.5	2.3	5.0
EBITDA margin (%)	21.8	15.4	16.5	17.5
EBIT margin (%)	19.0	11.3	11.5	11.6
Net margin adj. (%)	10.9	5.5	5.4	5.5
Div. payout (%)	25.0	25.0	25.0	25.0
Net gearing (%)	16.5	31.6	38.1	42.5
ROE (%)	19.4	9.2	9.4	9.5
ROCE (%)	22.7	11.5	11.4	11.2
EV/sales (x)	1.2	1.0	1.0	1.0
EV/EBITDA (x)	5.3	6.5	6.0	5.7
PBR (x)	1.9	1.3	1.2	1.2
PER adj. (x)	10.1	13.9	13.4	12.5
Dividend yield (%)	2.5	1.8	1.9	2.0

Source: Company, Standard Chartered Research estimates

Share price performance



Share price (%)	-1 mth	-3 mth	-12 mth
Ordinary shares	-9	-19	-26
Relative to index	-5	-15	-37
Relative to sector	-	-	-
Major shareholder	Minxi Xinghang (29.0%)		
Free float	37%		
Average turnover (USD)	15,952,779		

Source: Company, FactSet

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Important disclosures can be found in the Disclosures Appendix

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No remedy for higher-than-expected costs

We turn negative on Zijin after recent conversations with management, mainly because there seems no relief in costs. Zijin’s gold production cost was disappointing in 1Q13, due partly to the one-off suspension of its No. 3 processing plant. We had anticipated the alleviation of cost pressure once the processing plant resumes operation in 2Q13, but the company guides otherwise. Zijinshan gold mine’s decreasing grade continues to dominate the direction of production cost. In addition, cost-cutting at Norton Gold Field (“Norton Gold”, NGF AU) was not as effective as Zijin had expected. Zijin previously guided 25-30% cost reduction at Norton in 2013, which now looks unlikely.

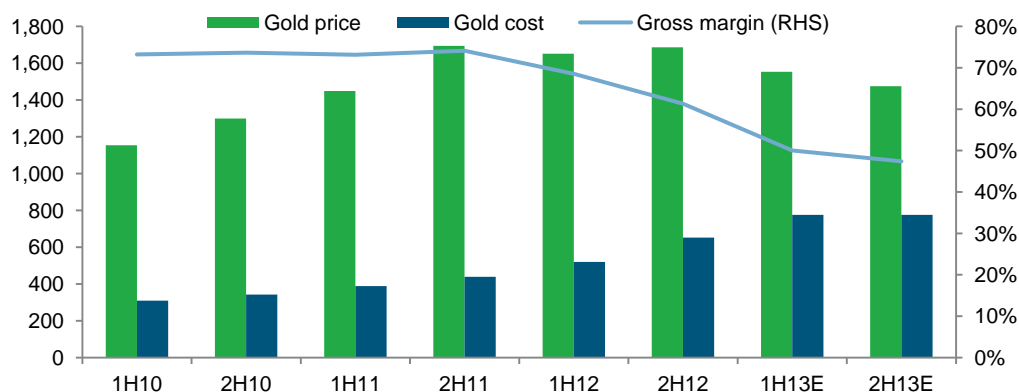
With the average grade at Zijinshan gold mine falling by 15-20% p.a., we think this translates into 25-30% p.a. cost increase for Zijin, without considering Norton Gold. The cut-off grade at Zijinshan gold mine has dropped to 0.3g/t in 2013 (from 0.46g/t in 2012 and 0.52g/t in 2011) and the average grade in 1Q13 was 0.42g/t (from 0.51g/t in 2012 and 0.62 g/t in 2011).

Assuming gold production cost stays at USD 777/oz in 2H13, the same level as in 1Q13, we estimate the gross margin in gold mining will drop to 47%, compared to 73-74% during 2010-11, when Zijin was considered a low-cost producer and produced gold at USD 318-414/oz (Figure 1).

We downgrade Zijin to Underperform, given disappointing costs, which would lead to weak earnings growth and ROE. We forecast Zijin’s net profit will increase at 3.6% CAGR over 2013-15, given our rising copper price outlook (and gold price being maintained at USD 1,500/oz). Average ROE could be around 9% in 2013-15E, less than half of the average of 23% in 2009-12 (Figure 2).

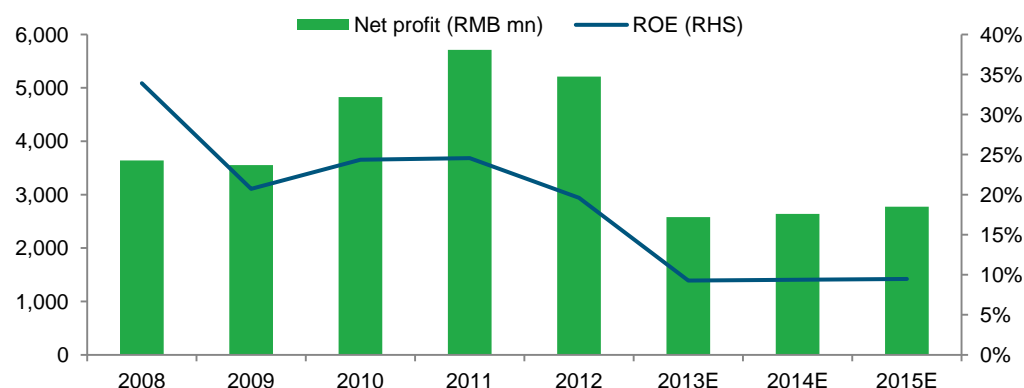
High cost = weak earnings growth and ROE

Fig 1: Zijin Mining – Gold production cost (USD/oz) and gross margin



Source: Company, Standard Chartered Research estimates

Fig 2: Zijin Mining – Net profit and ROE



Source: Company, Standard Chartered Research estimates



Fig 3: Zijin Mining – Forward PER



Source: Bloomberg, Standard Chartered Research estimates

Fig 4: Zijin Mining – Forward PBR



Source: Bloomberg, Standard Chartered Research estimates

Key highlight of our recent communications with management

- Management believes the largest risk lies in the volatility of commodity prices. It seems management has accepted the current production cost level and has limited measures to bring it down.
- Production cost in 1Q13, which was up 44% for both gold and copper, was much worse than the company's expectation of 10-15% increase. In addition, it guided (1) limited downside to cost with the resumption of operations at the No. 3 processing plant in Zijinshan gold mine, and (2) significant amounts of low-grade ore during stripping for Zijinshan copper mine, with Zijin to continue processing the low-grade ore. The cut-off grade at Zijinshan gold mine has fallen in the past two years and is likely to keep falling, as the company intends to extend Zijinshan's mine life by processing low-grade ore.
- Cost control at Norton has been disappointing. Average production grade in 1Q13 was at 1.65g/t, substantially higher than 1.42g/t in the previous three quarters (Figure 5), and we attribute this to low production cost in 1Q13. High-grade production might not be sustainable, in our view.
- Zijin is maintaining its production targets set at the beginning of 2013, although 1Q13 output for gold, zinc and iron ore were behind the quarterly run rate (Figure 6). Zijin estimates the impact from No. 3 processing plant maintenance would be about 1,300 kg gold output. Adding this to 1Q13 production, the annualised figure would be 31.6t, 4% short of the 33t target. The company has explained that 1Q is a slow production season for its iron ore because the mine is located in Xinjiang. Despite this, iron ore concentrate production represented a 38% YoY decrease in 1Q13.
- Zijin's board approved the issuance of a medium-term note of up to RMB 10bn, which it aims to realise in 3Q13. In addition, the company has been adding gold borrowing positions, taking advantage of its low interest rate. In 2012, Zijin increased RMB 2.4bn of gold borrowing financing and net added RMB 6.9bn bank loans. We estimate further new debt of RMB 3bn and RMB 2bn in new gold borrowing in 2013, rendering 51% net debt to equity, up from 32% in 2012. Zijin aims to keep the ratio below 60%.
- In June 2013, Zijin hired a new CEO, Wang Jianhua, who retired from Shandong Gold Group. Mr. Wang was chairman of Shandong Gold for seven years. Previously, he was in various positions in Shandong Silk Import & Export Corporation for 10 years. Zijin expects Mr. Wang to bring in new ideas and transfer the strong growth from Shandong Gold to Zijin. During his tenure, Shandong Gold's net profit grew to RMB 2,217mn in 2012 from RMB 418mn in 2007, representing a 25.5% CAGR.



Fig 5: Norton Gold Field – Quarterly operational results

	2Q12	3Q12	4Q12	1Q13
Ore milled (kt)	902	848	800	891
Feed grade (g/t)	1.42	1.40	1.44	1.65
Recovery (%)	94%	94%	93%	93%
Gold production (k oz)	38.9	35.7	34.3	44.1
Sales, price and cost				
Gold shipped (k oz)	35.9	41.1	38.0	44.1
Gold price (AUD/oz)	1,594	1,601	1,641	1,560
Cash cost (USD/oz)	947	1,281	1,377	1,033
Production cost (USD/oz)	1,291	1,613	1,733	1,303

Source: Company

Fig 6: Zijin Mining – 1Q13 production volume vs. FY13 targets

		2013 target	1Q13 actual	as % of target	Our 2013E
Gold bullion – mining	kg	33,000	6,658	20%	33,174
Gold bullion – refining	kg	47,000	17,108	36%	60,000
Copper	tonne	115,000	27,822	24%	125,719
Zinc ingot	tonne	150,000	42,798	29%	170,000
Zinc concentrate	tonne	80,000	6,360	8%	74,537
Iron concentrate	tonne	2,200,000	163,400	7%	2,200,000
Silver – mining	kg	125,000	34,581	28%	141,125

Source: Company, Standard Chartered Research estimates

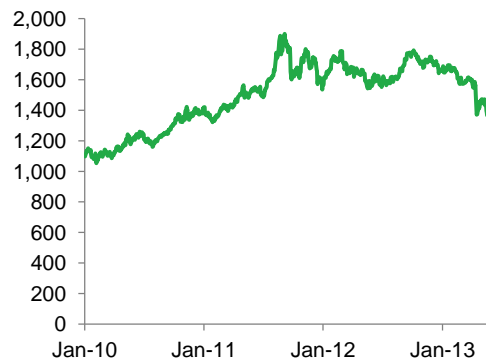
Earnings revision

We raise gold and copper cost assumptions and cut 2013/14 earnings forecasts by 35%/41% to RMB 2.58bn/2.64bn. Our forecasts are now 41%/37% below consensus. We believe consensus has not factored in cost inflation (or not factored enough of it). In 1Q13, Zijin reported RMB 720mn net profit. Gold and copper prices dropped 11% and 8% QoQ (Figures 7 and 8) and we expect weaker earnings for the remaining quarters of 2013.

*Zhaojin/Jiangxi
Copper offer better
exposure to
gold/copper*

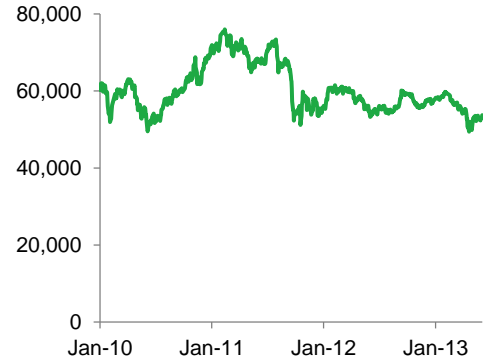
In our view, if the gold price rebounds, Zhaojin (1818 HK, OP, HKD 7.33, PT HKD 11.54) would be a better choice for gold exposure. We also think Jiangxi Copper (358 HK, IL, HKD 15.38, PT HKD 14.00) would make a better proxy for a copper price rebound.

Fig 7: Spot gold price (USD/oz)



Source: Bloomberg

Fig 8: SHFE copper price (RMB/t)



Source: Bloomberg



Fig 9: Zijin Mining earnings revisions – Key assumptions and financials

		2012	New			Old			Revision		
			2013E	2014E	2015E	2013E	2014E	2015E	2013E	2014E	2015E
Sales volume											
Gold - mining	tonnes	33.2	33.2	33.1	32.7	33.2	33.1	32.7	0%	0%	0%
Gold - refining	tonnes	58.3	60.0	60.0	60.0	50.0	50.0	50.0	20%	20%	20%
Copper	000 tonnes	106.6	125.7	137.9	156.2	125.7	137.9	156.2	0%	0%	0%
Zinc ingot	000 tonnes	154.0	170.0	170.0	170.0	150.0	150.0	150.0	13%	13%	13%
Iron ore	000 tonnes	2,401.4	2,200.0	2,200.0	2,200.0	2,200.0	2,200.0	2,200.0	0%	0%	0%
Benchmark price											
Gold	USD/oz	1,677	1,481	1,500	1,500	1,481	1,500	1,500	0%	0%	0%
Copper	USD/lb	3.60	3.44	3.86	4.08	3.44	3.86	4.08	0%	0%	0%
Zinc ingot	USD/lb	0.89	0.92	1.04	1.09	0.95	1.09	1.13	-3%	-5%	-4%
Realised price											
Gold	USD/oz	1,677	1,481	1,500	1,500	1,481	1,500	1,500	0%	0%	0%
Copper	USD/lb	3.02	2.94	3.30	3.49	2.94	3.30	3.49	0%	0%	0%
Zinc ingot	USD/lb	0.93	0.83	0.94	0.98	0.86	0.98	1.02	-3%	-5%	-4%
Iron ore	USD/t	97	121	123	120	104	104	104	16%	18%	15%
Cost											
Gold	USD/oz	596	777	877	944	690	721	751	13%	22%	26%
Copper	USD/lb	1.04	1.32	1.35	1.45	1.08	1.12	1.08	22%	20%	34%
Zinc ingot	USD/lb	0.95	0.81	0.85	0.82	0.82	0.85	0.80	-1%	0%	3%
Iron ore	USD/t	35	56	57	58	44	44	44	28%	30%	32%
Financials											
Revenue	RMB mn	47,874	46,515	48,788	49,979	43,575	45,896	47,176	7%	6%	6%
Gross profit	RMB mn	11,499	8,317	8,806	9,089	9,356	10,332	11,127	-11%	-15%	-18%
Operating profit	RMB mn	8,708	5,056	5,398	5,607	6,888	7,732	8,456	-27%	-30%	-34%
Net profit	RMB mn	5,212	2,580	2,640	2,773	3,987	4,438	4,853	-35%	-41%	-43%

Source: Company, Standard Chartered Research estimates



Income statement (RMB mn)					
Year-end: Dec	2011	2012	2013E	2014E	2015E
Sales	39,382	47,874	46,515	48,788	49,979
Gross profit	11,845	11,499	8,317	8,806	9,089
SG&A	(2,577)	(2,792)	(3,261)	(3,407)	(3,482)
Other income	299	410	200	200	200
Other expenses	0	0	0	0	0
EBIT	9,567	9,118	5,256	5,598	5,807
Net interest	(496)	(804)	(1,273)	(1,519)	(1,512)
Associates	205	243	200	200	200
Other non-operational	0	0	0	0	0
Exceptional items	0	0	0	0	0
Pre-tax profit	9,276	8,557	4,183	4,280	4,495
Taxation	(2,366)	(2,403)	(1,129)	(1,156)	(1,214)
Minority interests	(1,198)	(942)	(473)	(484)	(509)
Exceptional items after tax	0	0	0	0	0
Net profit	5,713	5,212	2,580	2,640	2,773
Net profit adj.	5,713	5,212	2,580	2,640	2,773
EBITDA	10,486	10,438	7,177	8,073	8,724
EPS (RMB)	0.26	0.24	0.12	0.12	0.13
EPS adj. (RMB)	0.26	0.24	0.12	0.12	0.13
DPS (RMB)	0.10	0.06	0.03	0.03	0.03
Avg fully diluted shares (mn)	21,812	21,812	21,812	21,812	21,812

Balance sheet (RMB mn)					
Year-end: Dec	2011	2012	2013E	2014E	2015E
Cash	6,180	7,473	5,602	5,860	3,891
Short-term investments	849	1,358	1,358	1,358	1,358
Accounts receivable	489	841	941	988	1,012
Inventory	7,160	11,602	12,223	12,794	13,085
Other current assets	3,254	3,058	3,204	3,287	3,329
Total current assets	17,932	24,334	23,329	24,288	22,675
PP&E	18,044	23,990	28,374	30,871	32,928
Intangible assets	339	497	497	497	497
Associates and JVs	2,920	4,411	4,611	4,811	4,811
Other long-term assets	13,085	14,123	15,222	16,116	17,001
Total long-term assets	34,388	43,021	48,703	52,294	55,236
Total assets	52,320	67,354	72,033	76,581	77,911
Short-term debt	3,815	6,400	6,400	6,400	6,400
Accounts payable	3,232	4,487	4,712	4,932	5,044
Other current liabilities	9,317	12,092	14,009	13,861	13,970
Total current liabilities	16,365	22,979	25,121	25,193	25,414
Long-term debt	2,361	6,655	9,655	12,655	12,655
Convertible bonds	0	0	0	0	0
Deferred tax	0	0	0	0	0
Other long-term liabilities	3,462	4,138	4,138	4,138	4,138
Total long-term liabilities	5,823	10,793	13,793	16,793	16,793
Total liabilities	22,188	33,771	38,914	41,985	42,207
Shareholders' funds	25,228	28,404	27,528	28,812	29,717
Minority interests	5,124	5,401	5,591	5,784	5,988
Total equity	30,352	33,805	33,119	34,596	35,705
Total liabilities and equity	52,539	67,577	72,033	76,581	77,911
Net debt (cash)	(4)	5,581	10,452	13,194	15,163
Year-end shares (mn)	21,812	21,812	21,812	21,812	21,812

Source: Company, Standard Chartered Research estimates

Cash flow statement (RMB mn)					
Year-end: Dec	2011	2012	2013E	2014E	2015E
EBIT	9,567	9,118	5,256	5,598	5,807
Depreciation & amortisation	919	1,320	1,921	2,475	2,918
Net interest	628	954	1,441	1,668	1,668
Tax paid	(2,366)	(2,403)	(1,129)	(1,156)	(1,214)
Changes in working capital	(2,048)	(1,536)	(474)	(316)	(161)
Others	(310)	(2,045)	(901)	(1,089)	(1,051)
Cash flow from operations	6,390	5,408	6,114	7,180	7,967
Capex	(7,476)	(7,996)	(6,000)	(6,000)	(6,000)
Acquisitions	(1,436)	(823)	(200)	(200)	(200)
Disposals	93	10	0	0	0
Others	1,115	(1,127)	(1,132)	(1,151)	(1,144)
Cash flow from investing	(7,704)	(9,936)	(7,332)	(7,351)	(7,344)
Dividends	(2,652)	(3,017)	(2,181)	(645)	(660)
Issue of shares	0	0	0	0	0
Change in debt	0	0	0	0	0
Other financing cash flow	5,185	8,952	2,686	1,074	(1,932)
Cash flow from financing	2,533	5,935	505	429	(2,592)
Change in cash	1,219	1,406	(713)	258	(1,969)
Exchange rate effect	(93)	(9)	0	0	0
Free cash flow	(2,523)	(3,411)	(86)	980	1,767

Financial ratios and other					
Year-end: Dec	2011	2012	2013E	2014E	2015E
Operating ratios					
Gross margin (%)	30.1	24.0	17.9	18.0	18.2
EBITDA margin (%)	26.6	21.8	15.4	16.5	17.5
EBIT margin (%)	24.3	19.0	11.3	11.5	11.6
Net margin adj. (%)	14.5	10.9	5.5	5.4	5.5
Effective tax rate (%)	25.5	28.1	27.0	27.0	27.0
Sales growth (%)	39.7	21.6	-2.8	4.9	2.4
Net income growth (%)	18.3	-8.8	-50.5	2.3	5.0
EPS growth (%)	-21.1	-8.8	-50.5	2.3	5.0
EPS growth adj. (%)	-21.1	-8.8	-50.5	2.3	5.0
DPS growth (%)	0.0	-40.3	-50.5	2.3	5.0
Efficiency ratios					
ROE (%)	24.4	19.4	9.2	9.4	9.5
ROCE (%)	29.7	22.7	11.5	11.4	11.2
Asset turnover (x)	0.9	0.8	0.7	0.7	0.6
Op. cash/EBIT (x)	0.7	0.6	1.2	1.3	1.4
Depreciation/capex (x)	0.1	0.2	0.3	0.4	0.5
Inventory days	70.5	94.1	113.8	114.2	115.5
Accounts receivable days	5.4	5.1	7.0	7.2	7.3
Accounts payable days	28.2	38.7	44.0	44.0	44.5
Leverage ratios					
Net gearing (%)	0.0	16.5	31.6	38.1	42.5
Debt/capital (%)	17.2	29.4	34.2	37.1	36.3
Interest cover (x)	15.2	9.6	3.6	3.4	3.5
Debt/EBITDA (x)	0.6	0.9	2.0	2.2	2.2
Current ratio (x)	1.1	1.1	0.9	1.0	0.9
Valuation					
EV/sales (x)	1.7	1.2	1.0	1.0	1.0
EV/EBITDA (x)	6.5	5.3	6.5	6.0	5.7
EV/EBIT (x)	7.1	6.1	8.8	8.7	8.6
PER (x)	11.7	10.1	13.9	13.4	12.5
PER adj. (x)	11.7	10.1	13.9	13.4	12.5
PBR (x)	2.1	1.9	1.3	1.2	1.2
Dividend yield (%)	3.3	2.5	1.8	1.9	2.0



Disclosures appendix

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SCB makes a market in securities issued by the following companies: Zijin Mining Group Co. Ltd.



Date	Recommendation	Price target	Date	Recommendation	Price target	Date	Recommendation	Price target
1 5 Jul 10	IN-LINE	4.11	4 14 Jun 11	OUTPERFORM	4.78	7 13 Aug 12	IN-LINE	2.86
2 28 Jul 10	IN-LINE	3.59	5 26 Jul 11	OUTPERFORM	5.23	8 6 Oct 12	OUTPERFORM	3.80
3 28 Sep 10	OUTPERFORM	4.95	6 1 Nov 11	OUTPERFORM	4.90	9 20 Apr 13	OUTPERFORM	2.69

Source: FactSet prices, SCB recommendations and price targets

Recommendation Distribution and Investment Banking Relationships

	% of covered companies currently assigned this rating	% of companies assigned this rating with which SCB has provided investment banking services over the past 12 months
OUTPERFORM	56.0%	13.6%
IN-LINE	33.2%	12.4%
UNDERPERFORM	10.7%	12.3%

As of 31 March 2013

Research Recommendation

Terminology	Definitions
OUTPERFORM (OP)	The total return on the security is expected to outperform the relevant market index by 5% or more over the next 12 months
IN-LINE (IL)	The total return on the security is not expected to outperform or underperform the relevant market index by 5% or more over the next 12 months
UNDERPERFORM (UP)	The total return on the security is expected to underperform the relevant market index by 5% or more over the next 12 months

SCB uses an investment horizon of 12 months for its price targets.

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