4 May 2012

Global mining

Turning more positive – fundamentals improving in 2H

	Ticker	Rec	Mkt cap (US$m)	Ccy	Price	PT	Up/ dn (%)	PER 2012E	PER 2013E	EV/EBITDA 2012E	EV/EBITDA 2013E	PBR 2012E	PBR 2013E
Rio Tinto	RIO LN	OP	108,598	GBP	34.39	49.20	43%	6.9	5.3	3.6	2.5	1.3	1.1
China Shenhua	1088 HK	OP	88,577	HK$	34.55	40.42	16%	11.4	10.2	6.2	5.1	2.1	1.8
Zhaojin Mining	1818 HK	OP	4,112	HK$	10.94	23.59	116%	10.9	9.1	8.8	6.9	3.1	2.5
IRC	1029 HK	OP	485	HK$	1.12	1.78	59%	nm	nm	nm	26.9	0.6	0.6

Share price as of 3 May 2012
Source: Companies, FactSet, Standard Chartered Research estimates

- We think there could be a squeeze in resource shares after the past 3-month underperformance. Investors seem underweight and we see commodities strengthening into H2.
- We downgraded the sector in mid-February but it now seems a crowded trade to be bearish China.
- Shares typically move well ahead of improving fundamentals and we think Q2 will be the low.
- Gold shares look especially attractive for a major bounce, given their underperformance.
- Our top picks are Rio Tinto, IRC, China Shenhua and Zhaojin Mining.
- For the latest details on our 2nd Earth's Resources conference, please contact your sales representative.

Resource shares set for a squeeze, especially miners

Investors are negative on this space as they were in November 2011 and we sense that they are too focused on the sluggish Chinese economy. We highlighted our fears about China when we downgraded the sector on 16 Feb because we felt then that investors were too hopeful of big stimulus packages after the Chinese New Year. Now, we think equity markets will look through this sluggishness and begin to focus on a stronger 2H. If commodities such as copper and iron ore can be as resilient as they have been during a Chinese slowdown, imagine where they could go if China reaccelerates and the US economy continues to strengthen. Our top picks among the mining companies are Rio Tinto, IRC, Zhaojin Mining, and China Shenhua.

We are in no way changing our house view that copper prices could face near-term headwinds for price increases. As reported by our commodity team of Judy Zhu and Han Pin Hsi in their report, *Copper – Cu at the warehouses* (26 April 2012), they were surprised by how much copper is being stored in warehouses. Copper has baffled investors, to say the least. Industry thinking teaches that when traders accumulate copper inventory, like in China, prices would come down sooner rather than later.

Price action in the past week has indicated the opposite, as copper was squeezed 6% amid rising copper inventories. We recall trader Yasuo Hamanaka and how the 500,000 tonnes of copper he bought illegally was sold back into the market in 1996. The price of copper collapsed, falling 35% over 6-month period, and Sumitomo wore a US$2.6 billion trading loss.

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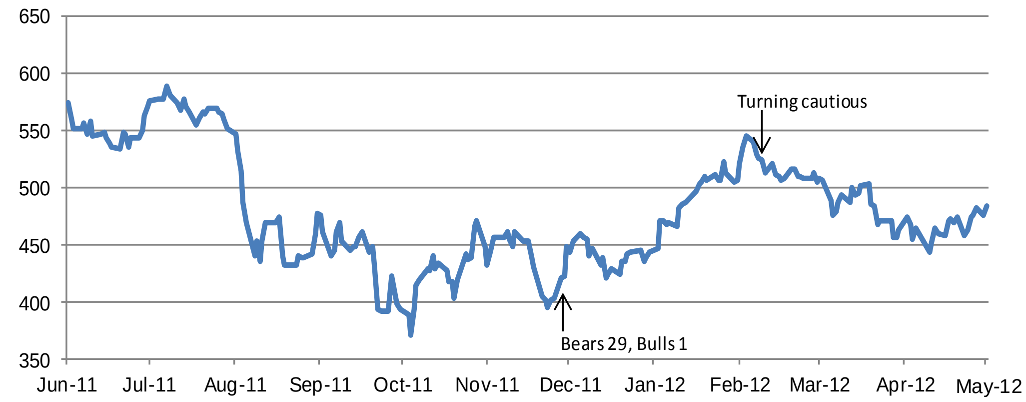
Important disclosures can be found in the Disclosures Appendix

Fig 1: SXPP Index – our sector calls since November 2011



Source: Company, Bloomberg

How much copper is being stored

Photos from the report (see below) highlight some interesting sights. Copper plates were piled to the maximum allowable height (based on weight so as not to damage the cement floors). The covered warehouses were full. The staff car park was used to store copper. The driveway between warehouses was blocked by copper. We were told it could not accept additional inventory until existing inventory was shipped out. The two analysts noted that although copper is a clear headwind for price increases, they would caution investors not to be too bearish, especially in regard to price expectations for H2. They argued in the note that risk appetite could suddenly turn positive, especially if our expectation of stronger global economic growth in H2 proves to be accurate.

Fig 2: Entrance to Waigaoqiao bonded area in eastern Shanghai

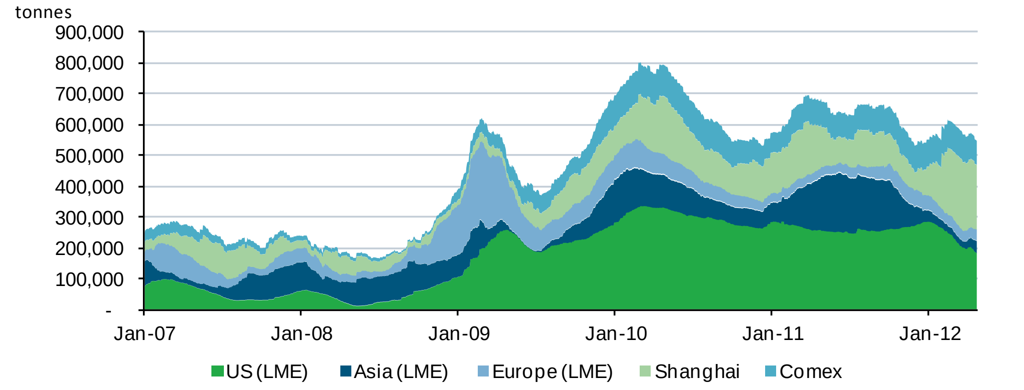
Source: Standard Chartered Research

Fig 3: Dude, where is my car? Staff car park now used to store copper

Source: Standard Chartered Research

The figure below illustrates that a significant amount of copper inventory has moved from LME warehouses in Europe and the US into China. As of today, the Shanghai Metal Exchange had some 205kt of copper inventory. Judy and Han Pin estimate that total copper inventory in China have reached 1 million tonnes, including stocks in bonded warehouses and elsewhere. This implies the current global copper inventory (reported and others) is around 1.3 million tonnes, or 25 days of global consumption.

Fig 4: Global copper inventory (reported, in metal exchanges)



Source: Bloomberg, Standard Chartered Research

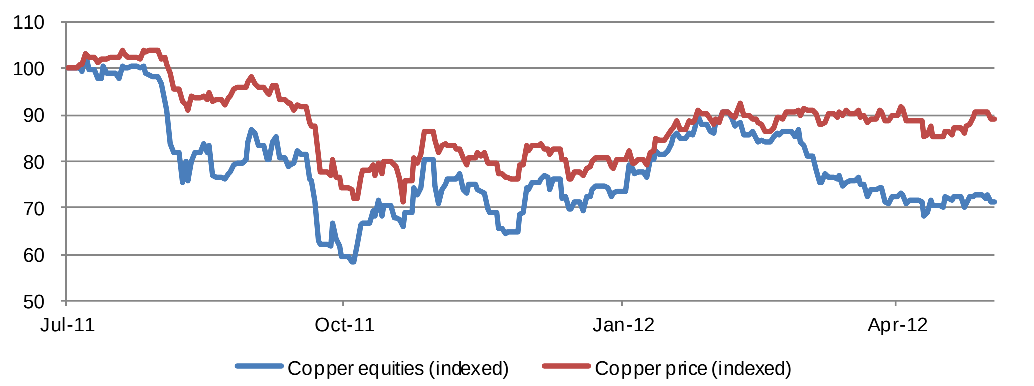
Equities typically move well ahead of the fundamentals

We learnt the hard way in late 2008 and also mid-2011 that we tend to focus only on fundamentals when making calls on the sector. After licking our wounds, we now feel the best way to call this sector is to upgrade when investors seem most bearish, and downgrade when the sector seems crowded. It sounds obvious but this contrarian guide is easy to forget and today, we sense many investors are trying to find negatives in the sector rather than positives.

The most obvious negative for big-cap miners in the past 3 years has been the sharp cost inflation in the industry. If we had a dollar every time we heard an investor recently commenting on BHP’s capex spike on their outer harbor expansion in the Pilbara from US$5 billion to US$22 billion, we could now retire. We agree, we don’t like the capex plans for iron ore.

We think BHP, Rio Tinto and Fortescue and every other producer should scale back their growth plans because investors are tired of seeing returns going to everyone but themselves. Investors want dividends right now but CEOs still seem to think at least for iron ore that China has another 10 years of urbanisation to go. This is not part of our call today – we could write extensively on our view that big-cap miners have been dead money for most of the last year. What concerns us today is whether these stocks will bounce in the next couple of months. Our answer is yes, and we believe now is the time to get involved again in this space. Investors, to our mind, are clearly not positioned for a rally and the pain trade seems to be up.

Fig 5: Copper equities vs copper prices (indexed 1 July 11 = 100)

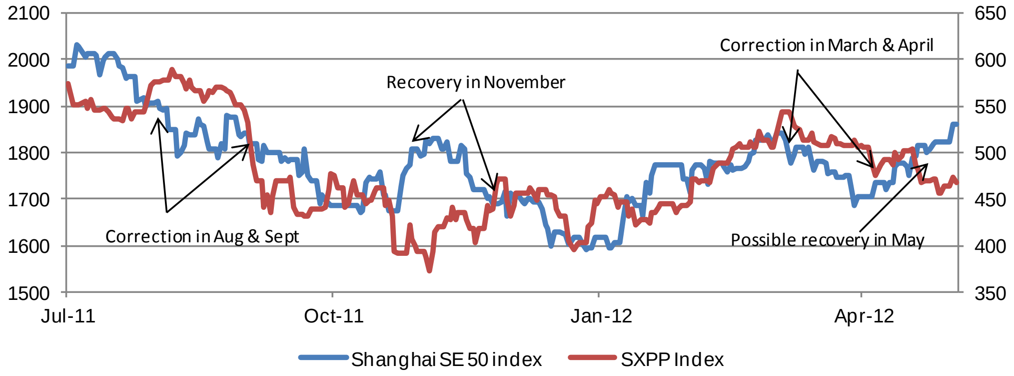


Source: Bloomberg

China A shares another good warning sign

China A shares are arguably the best lead indicator of resource stocks. In our opinion, local investors in the A share market seem to have a better read of the Chinese economy than other markets, and this week's strong move up tells us that now could be a good time to look at this space again. Recall November 2011, when the sector was about to jump 40–50%, and in mid-February, when the shares were about to fall.

Fig 6: Shanghai SE 50 index vs SXPP index



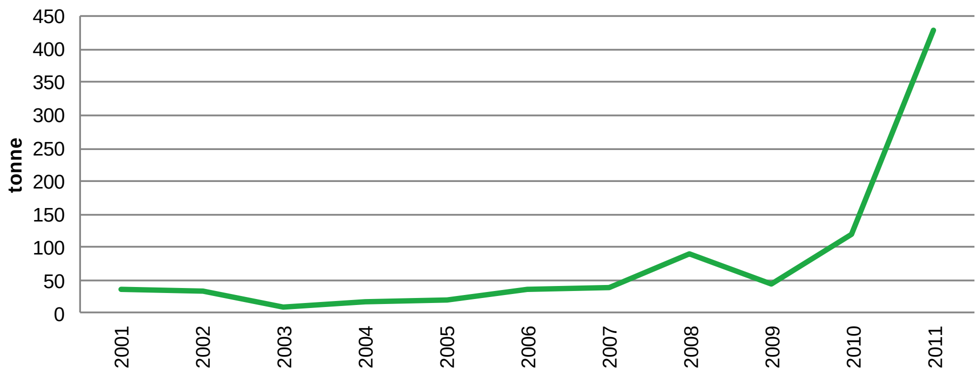
Source: Bloomberg

Gold market seems ripe for next leg-up

We are surprised at how quickly investors and commentators have lost interest in the gold market. Broker reports talk of a more sanguine outlook, with prices described as "range bound" at best. We disagree with this view and stick to Yan Chen's study entitled, *In gold we trust* (June 2011), which illustrates supply growth from new mines will be just 3.5% pa in the next 5 years.

We are increasingly buoyed by the prospects of rising gold imports into China from Hong Kong. The November 2011 import number of 103 tonnes surprised the market, and since then, monthly imports have slowed to 30-50 tonnes. Even then, it is a huge increase from the monthly average of 10 tonnes imported in 2010 and shows China is now a big player in the global market. With supply constrained and demand growing from central banks, we think gold will surprise on the upside. Add to this the likelihood that the debt crisis in Europe will linger for many years, pressure from monetary policy to print more money would continue. The Chinese are waking up to this as quickly as everyone else and searching for new safe assets like gold. This may explain why the surge in Chinese gold imports could be the beginning of a 5–10 year cycle, just as it was for iron ore in 2003 when China ramped up on its steel making capacity.

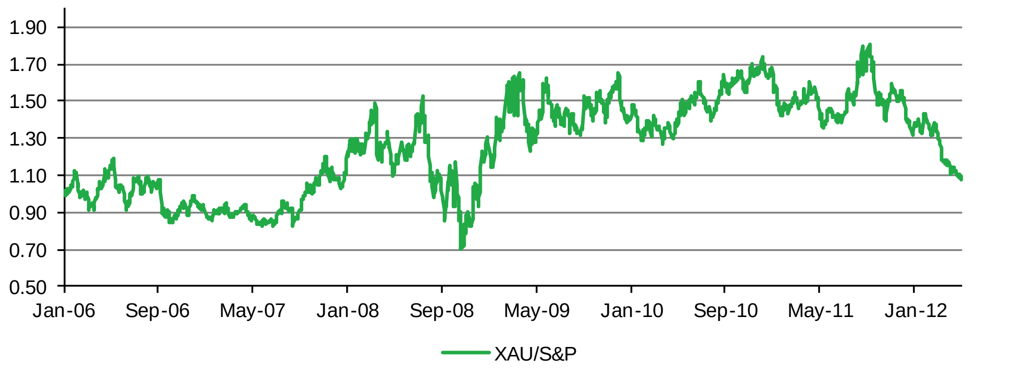
Fig 7: China gold imports from Hong Kong now running at 14% of global consumption



Source: Company, Bloomberg

Gold shares have underperformed the S&P 500 by a significant margin in the last 4 months, as illustrated in the chart below. This is despite gold prices not breaking down and sitting right on the support line. This is one space that can quickly wake up again and we are heartened by the lack of interest from investors. We look at a name like G Resources (1051 HK, Not rated) and scratch our heads as to why its current share price level of HK$0.50 is less than its price two years ago when its Martabe project was just a dream. Today, this project is only 8 weeks from starting production (it is one of the six site visits we are offering investors around our 2nd Earth's Resources conference during 20–21 June 2012).

Fig 8: XAU (Gold miners) / S&P indices – Gold shares have given up most of their gains



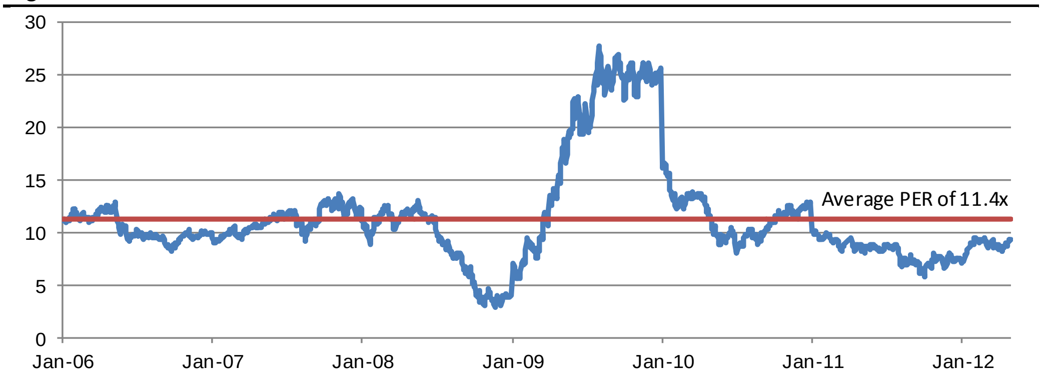
Source: Bloomberg

Rio Tinto and China Shenhua are our top picks

Our top picks among the mining companies we cover are Rio Tinto, IRC, Zhaojin Mining and China Shenhua. If you can buy big-cap miners on 8–9x PER, that is good enough for us to call the sector a buy, when investors are underweight at the same time. In reality, valuations have compressed since mid-February and share prices have fallen while copper and iron ore prices have risen. This is a classic early warning sign, in our view.

The figure below illustrates Rio Tinto is trading at 7.0x 2012E PER, well below the average PER of 11.4x. The company – on the verge of delivering two high-quality projects, Oyu Tolgoi in Mongolia and Pilbara iron ore expansions in Western Australia – is looking inexpensive based on its PER, in our view. We regard Oyu Tolgoi as the best copper-gold project under development and Rio Tinto took control of it last month. The project is scheduled to commence trial production in Q3 2012 with commercial production from mid-2013. Moreover, we think Rio Tinto's Pilbara expansions (100mt in phases 1 and 2) are easier to develop than the iron ore expansions of BHP and Vale. We believe Rio Tinto is ahead of the curve in its iron ore expansions (both with Cape Lambert expansion and technological innovations). We believe the company now has one of the best balance sheets among the big 6 miners with 12% net gearing, which should give it enough firepower to be active in M&A markets even after a step-up of shareholders' returns.

Fig 9: Rio Tinto – 12-mth forward PER since 2006



Source: Company, Bloomberg

In summary, it is usually right to buy this space when it feels wrong

Presenting a buy case on the miners when there are re-emerging concerns about the Eurozone, and in the face of significant copper inventories in China would go against the better judgement of most sensible investors. This is why we believe it is the right time to move in because the worst may now be in the price. As we begin to focus on 2H, we will probably look back and realise Q2 was the low in corporate earnings for the mining sector.

Fig 10: Mining sector – comps table

Name	Ticker	Recom	Stock Currency	Price in Stock Currency	Current Market Cap (USD)	Price Target in Stock Currency	PER 2012	PER 2013	EV/EBITDA 2012	EV/EBITDA 2013	PBR 2012	PBR 2013
Energy coal												
Adaro Energy	ADRO IJ	OUTPERFORM	IDR	1,870	6,503	2,419	11.2	7.8	6.5	4.0	2.4	2.0
Bumi Resources	BUMI IJ	OUTPERFORM	IDR	2,025	4,573	4,503	5.9	4.4	2.6	1.7	1.8	1.4
Indo Tambangraya Megah	ITMG IJ	IN-LINE	IDR	39,050	4,797	36,647	10.2	8.7	6.6	5.5	5.0	4.5
Sakari Resources	SAR SP	OUTPERFORM	SGD	2.10	1,919	2.86	12.4	5.9	6.7	3.4	2.6	2.3
China Shenhua Energy	1088 HK	OUTPERFORM	HKD	34.55	88,577	40.42	11.4	10.2	6.2	5.1	2.1	1.8
China Coal Energy	1898 HK	IN-LINE	HKD	9.03	15,432	9.98	8.5	7.9	8.1	6.7	1.1	1.0
Yanzhou Coal Mining	1171 HK	IN-LINE	HKD	16.62	10,537	15.04	8.7	8.4	7.0	6.5	1.4	1.2
Coking coal												
Shougang Fushan Resources Group	639 HK	OUTPERFORM	HKD	2.76	1,914	4.98	7.7	7.7	2.4	1.9	0.7	0.7
Hidili Industry Int'l Development	1393 HK	IN-LINE	HKD	2.74	728	2.20	7.6	6.1	4.4	4.1	0.6	0.6
Mongolian Mining Corp	975 HK	OUTPERFORM	HKD	6.41	3,061	8.11	10.6	9.3	7.1	5.7	2.7	2.1
SouthGobi Resources	1878 HK	OUTPERFORM	HKD	53.90	1,400	67.75	73.0	28.7	12.2	8.7	1.9	1.7
Mongolia Energy Corp	276 HK	UNDERPERFORM	HKD	0.67	571	0.31	nm	nm	nm	nm	0.3	0.3
Winsw ay Coking Coal Holdings	1733 HK	IN-LINE	HKD	1.77	865	2.53	4.4	4.0	3.1	2.4	0.8	0.7
Gold												
Zhaojin Mining Industry	1818 HK	OUTPERFORM	HKD	10.94	4,112	23.59	10.9	9.1	8.8	6.9	3.1	2.5
Zijin Mining Group	2899 HK	OUTPERFORM	HKD	2.60	7,310	4.90	5.9	5.3	3.5	2.9	1.6	1.3
Real Gold Mining	246 HK	UNDERPERFORM	HKD	8.81	1,028	6.27	4.9	4.2	0.9	0.0	0.9	0.7
Philex Mining Corp	PX PM	IN-LINE	PHP	24.75	2,886	25.00	24.8	23.5	15.2	15.0	3.1	2.8
Steel & iron ore												
Angang Steel	347 HK	OUTPERFORM	HKD	5.40	5,036	10.03	14.9	13.9	5.1	4.6	0.5	0.5
Maanshan Iron & Steel	323 HK	OUTPERFORM	HKD	2.22	2,204	3.93	9.0	8.6	3.6	3.5	0.4	0.4
China Vanadium Titano-Magnetite	893 HK	OUTPERFORM	HKD	1.84	492	3.59	5.2	4.9	2.5	1.9	0.9	0.7
IRC	1029 HK	OUTPERFORM	HKD	1.12	485	1.78	nm	nm	nm	26.9	0.6	0.6
Base and minor metals												
Chalco (Aluminum Corp of China)	2600 HK	UNDERPERFORM	HKD	3.76	6,555	3.80	14.0	11.1	7.6	6.8	0.7	0.7
United Co Rusal	486 HK	IN-LINE	HKD	5.49	10,751	7.00	6.8	5.4	6.1	5.0	0.6	0.5
Jiangxi Copper	358 HK	UNDERPERFORM	HKD	19.36	8,641	18.00	6.9	5.3	5.9	3.6	1.2	1.0
China Molybdenum	3993 HK	OUTPERFORM	HKD	3.17	1,992	5.70	9.4	8.1	5.2	4.2	1.2	1.1
Recylers												
China Metal Recycling (Holdings)	773 HK	OUTPERFORM	HKD	8.90	1,306	14.52	5.1	4.1	4.9	3.6	1.3	1.0
Chiho-Tiande Group	976 HK	OUTPERFORM	HKD	4.19	563	6.11	7.8	5.1	6.1	4.9	1.5	1.2
Diversifieds												
Anglo American (Blackout)	AAL LN	Blackout	GBP	2,375	46,528	Blackout	Blackout	Blackout			Blackout	Blackout
BHP Billiton	BLT LN	OUTPERFORM	GBP	2,018	174,083	2,560	9.6	8.6	5.6	4.7	2.5	2.1
Glencore International	805 HK	OUTPERFORM	HKD	55	48,632	64	9.7	8.1	12.0	10.0	1.5	1.3
Rio Tinto	RIO LN	OUTPERFORM	GBP	3,439	108,598	4,920	6.9	5.3	3.6	2.5	1.3	1.1
Vale SA (Hong Kong)	6210 HK	IN-LINE	HKD	175	117,508	210	5.9	5.2	4.4	3.7	1.2	1.0
Xstrata	XTA LN	IN-LINE	GBP	1,169	55,518	1,220	9.7	7.0	5.5	4.0	1.1	1.0
Citic Pacific	267 HK	UNDERPERFORM	HKD	12.86	6,049	12.70	7.3	6.7	12.7	11.3	0.6	0.5

Share price as of 3 May 2012
Source: Company, FactSet, Standard Chartered research estimates

Disclosures appendix

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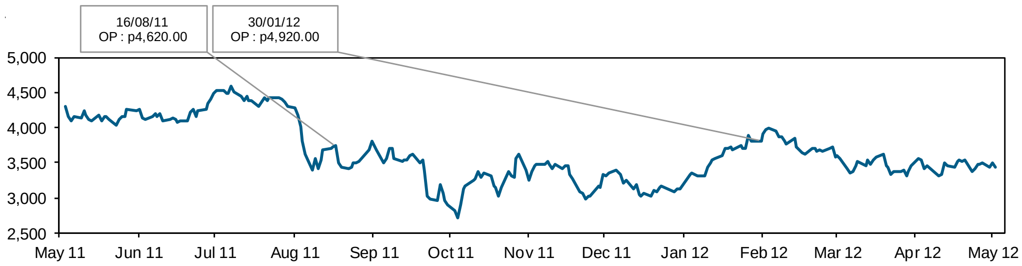
Rio Tinto PLC



Source: FactSet prices / SCB ratings and price targets

China Shenhua Energy Co. Ltd.

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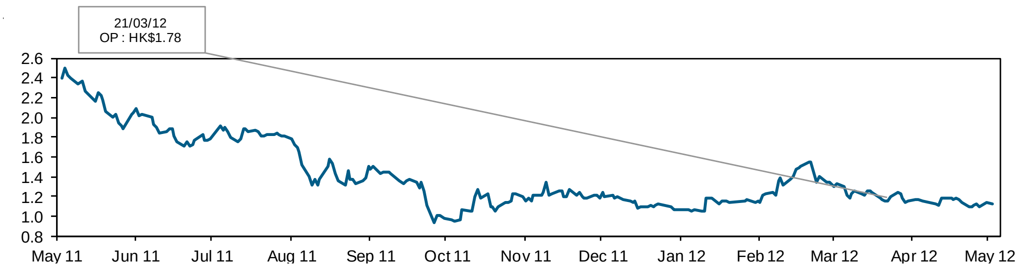

Source: FactSet prices / SCB ratings and price targets

Zhaojin Mining Industry Co. Ltd.

Source: FactSet prices / SCB ratings and price targets

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	% 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	58.6%	10.4%
IN-LINE	31.7%	13.1%
UNDERPERFORM	9.7%	13.0%

As of 31 March 2012

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

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