國都香港 GUODU HONG KONG

30 Nov 2009

Company note

GCL-Poly Energy Holdings Limited (3800)

BUY Target price: $3.45

Guodu's view:

- **Strong demand in the PV industry in 2010** We forecast the global demand of poly-silicon will soar 96% in 2010 and most importantly the demand will come from China. As the leading poly-silicon producer in China, GCL-Poly will benefit from it. Its production lines are fully operated at present.
- **Cost reduction driven by ramping output** The capacity of poly-silicon will reach 18,000MT by the end of 2009 and further rise to 21,000MT at the end of next year. This will drive the unit cost to below US$30/kg which is very close to the level of leading companies in the world.
- **Good impact expected in China's new policy** The new policy of the poly-silicon industry has reduced the chance of cut throat competition and positive for the company. After CIC becomes the second largest shareholder, we believe the company has stronger support from the government.
- **Penetrates into midstream and downstream operation** A wafer plant with a capacity of 1GW will be complete in 2H10. With 15.4GW long-term contract, the profit will be guaranteed. Its first 20MW solar power plant in Xuzhou will be on grid by the end of 2009.
- **We initiate coverage of GCL-Poly with a BUY rating and target price of $3.45** Amid the contribution of the PV project, we forecast the earnings will jump to RMB2614m (EPS: RMB0.169) for 2010. The stock is trading at 13.7x PER for 2010 only despite recording huge gain this month. We believe the fair value is $3.45 (based on 18x PER for 2010 which will be in-line with the PER of the Chinese solar companies listed in the US market). Recommend **BUY**.

Sector: New energy

Key data

Price: $2.64

52-week high/low: $3.84/0.44

Board lot: 1,000

2009 PER: n.a.

2009 dividend yield: 0.9%

Enterprise value: RMB34.42bn

Market cap.: $40.85bn

Share outstanding: 15.47bn

Major shareholder:

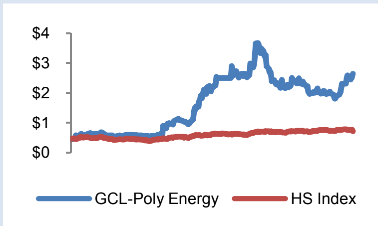
Zhu Gongshan (39.82%)

China Investment Corporation (20.11%)

Performance:

1month	3month	12month
32.7%	8.2%	473.9%

Share price vs index (1-year)



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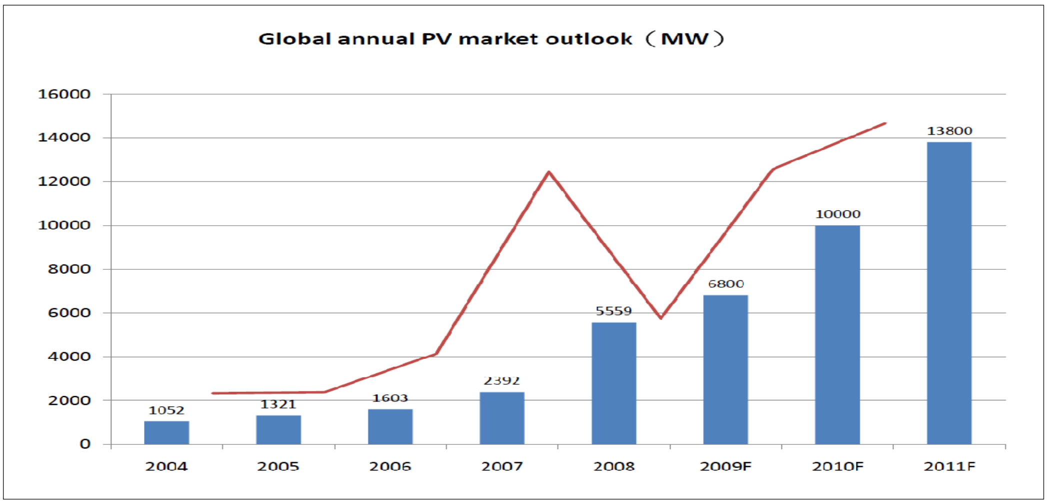
Investment highlights

Strong demand in the PV industry in 2010 – The global photovoltaic (PV) industry is in a downturn in 2009 but we are bullish on the long-term prospect, forecasting an increase of 10GW and 13.8GW installed capacity in 2010 and 2011 respectively, and the poly-silicon demand will increase to 114,000 metric tons (MT) in 2010 from this year's 58,000MT. China is now the largest PV producer in the world with an output of 2,900MW and poly-silicon consumption of over 24,000MT in 2009. However, half of the demand of poly-silicon is relying on imports. The management of GCL-Poly guided that the domestic demand is still strong despite the downturn and they are going to expand their output to 20,000MT in 2011 from 1,850MT only in 2008.

Global annual PV market outlook (MW)



Source: EPIA

Reducing unit cost as output is ramping up – GCL-Poly has finished the expansion of Xuzhou phase III in June 2009, boosting its poly-silicon production capacity to 18,000MT by the end of this year. Thanks to improvement of manufacture technique, the capacity will increase further to 21,000MT at year-end 2010. We expect the output to exceed 17,000MT next year compared to 7,500MT in 2009. Benefited from its capacity increase and ring-closing technique, we forecast the unit cost of production will drop significantly to US$28.5/kg in 2010 from this year's US$38.7/kg, which will be the lowest in China. Even though the price of poly-silicon is on a downtrend, we believe the gross profit margin of poly-silicon will rise to 38% next year. Direct purchase of electricity from its own power plants, which is pending government approval, will further reduce the unit cost in future.

Beneficiary of government new policy – The Chinese government announced a new policy about the poly-silicon industry in October 2009, raising the entry barrier by setting a cap on electricity consumption in the manufacture process and limiting new investment. We note that for any new poly-silicon production line, the electricity consumption is not allowed to be over 60KWh/kg which is significantly below the level that Siemens method could reach. It implies that only new production method such as Fluidized bed reactor and AsiMI method etc. can be approved in future. As GCL-Poly has already finished the expansion before the policy is announced, it is free from the restriction and will take advantage as a consequence of reduced competition. We expect the market share of the company to increase to 68% in 2010 from 30% in 2008 in China.

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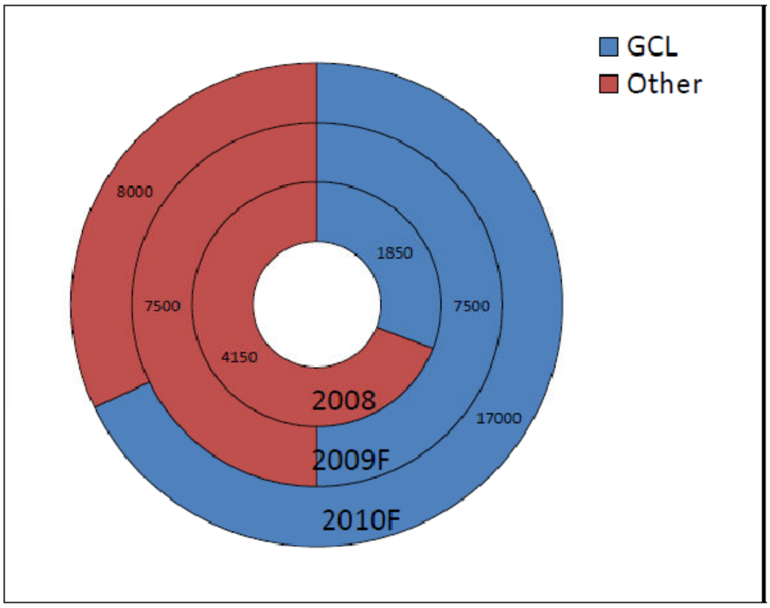
GCL compared to total poly-silicon production capacity in China from 2008 to 2010



Source: EPIA, Guodu Securities

Penetrate into midstream wafer production process – GCL-Poly is vertically integrating its business towards the middle-stream of the PV industry. The company is building a wafer plant with a total capacity of 2GW and it will be able to produce monocrystalline wafers and multicrystalline wafers both. The construction of the plant will be complete at year-end 2010. With a 15.4GW wafer long-term contract from 2008 to 2015, the sales of the company will be guaranteed and an addition of 10-14% will be added to the gross profit margin. The vertical integration also leads to better quality control and reduces the risk of sharp deterioration in earnings caused by decline of poly-silicon price.

Positive on the development of solar farm based on its experience in the power business – Besides the PV operations, the core business of GCL-Poly includes the power and steam cogeneration. It is one of the largest independent power companies in Eastern China with an operational history of over 10 years, so it has already built a solid relationship with grid companies. We see this is a competitive strength of the company when it enters into the solar farm business. A solar farm in the Jiangsu province with an installed capacity of 20MW invested by the company will be complete by the end of this year. Moreover, the company is planning to build solar farms in Europe, United States and China. China Investment Corporation, the sovereign fund of China, has just become the second largest shareholder of the company through subscription of 3.1bn new shares. CIC and the company will set up a joint venture company to develop PV projects and other solar energy projects. Backed by CIC, the company's position will strengthen further.

Income statement & balance sheet analysis

Poly-silicon price remains on a downtrend - We are positive on the PV industry in the long term but the supply of poly-silicon is still outpacing the demand at present. Our analysis suggests that there will be a surplus of 11,820MT and 9,260MT in 2009 and 2010 respectively. As a result, the price of poly-silicon will remain on a downtrend. The selling price of poly-silicon of GCL-Poly is assumed to decrease by 20% each year for three reasons.

- The decrease of price is inevitable as the price of the solar energy should be comparable with the price of the traditional energy eventually in order to make the solar energy competitive.
- Capacity expansion of the Big Seven will be complete in 2010 with lower unit cost as the new FBR production technique will be employed.
- There is a discount in the price of poly-silicon made in China due to inferior quality.

Supply and demand forecast in the global PV market

Year	2008	2009F	2010F
Annual increased installed capacity （GW）	5559	6800	10000
Production in cell (GW)	7.9	9.6	14.1
Ratio for silicon cell	86%	81%	81%
Silicon consumption　g/W	8	7.4	6.9
Demand of solar-grade poly-silicon（MT）	55000	57680	114210
Supply of the seven traditional companies（MT）	28350	40500	55950
Supply of other overseas companies (MT)	5000	14000	24000
Domestic production（MT）	6000	15000	25000
Total supply（MT）	39350	69500	104950
Gap/(Surplus) （MT）	15650	(11820)	(9260)

Source: EPIA, Guodu HK Research

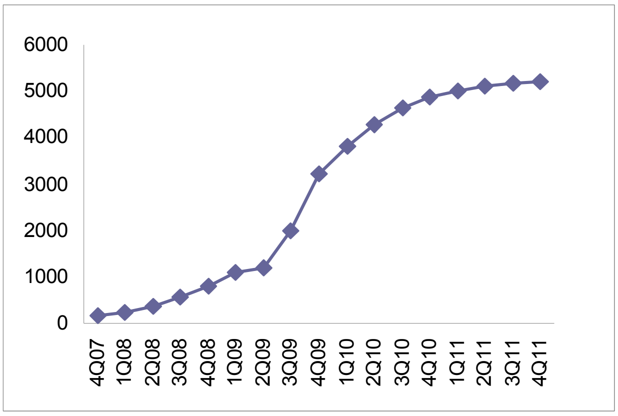
Average selling price of poly-silicon and wafer for GCL-Poly

Price	Aug – Dec 2009	2010F	2011F
Poly-silicon (US$/kg)	56.5	46.4	37.1
Wafer (USD/W)	0.8	0.69	0.60

Source: Guodu HK research

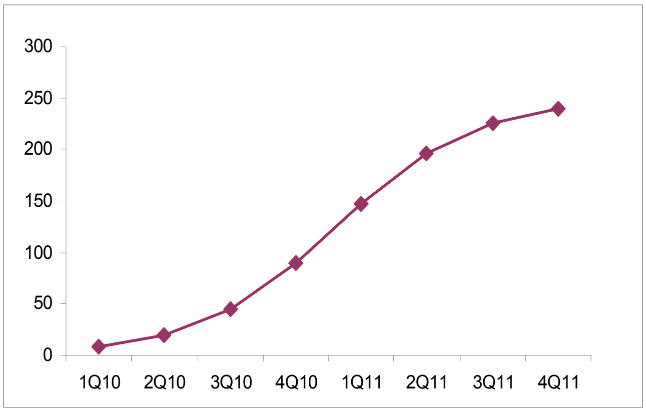
Explosive growth in sales of poly-silicon – In spite of the downturn, GCL-Poly will be in a better position than the peers and the sales of poly-silicon and wafer will experience accelerating growth for two reasons. Firstly, the company is easy to grab market share through its geographic advantage, as many large companies of solar cell such as Suntech, JA solar and Trina solar are located in the Jiangsu province. Secondly, the company will face less competition in China in the next two years thanks to the new government policy. When the production becomes mature in 4Q11, the capacity of poly-silicon will reach 1,750MT per month. Based on a three-stage growth model, we make the following assumptions on the output of poly-silicon and wafer and the corresponding sales. Not all poly-silicon output is sold because some poly-silicon is internally used for the manufacture of wafer.

Output of poly-silicon (metric tons)



Source: Guodu HK Research

Output of wafer (MW)



Source: Guodu HK Research

Sales of poly-silicon and wafer

Year	2007	2008	Aug-Dec 2009	2009 full-year	2010	2011
Poly-silicon output (MT)	154	1850	4529	7466	17599	20493
Self-use (MT)	1	320	111	267	1227	5745
External sales (MT)	153	1530	4417	7199	16371	14748
Sales of wafer (MW)	0	39.2	13.8	33.0	161.5	809.1

Source: GCL-Poly, Guodu HK Research

Huge increase in earnings from 2010 onwards - Jiangsu Zhongneng has consolidated into the financial statement of GCL-Poly and the PV projects have become the major business of the company since August 2009. Thus, we forecast a 58% increase in revenue and the gross profit will double in 2009. The revenue will further increase by 74% and the gross profit will jump 184% in 2010. The power and steam cogeneration business, which provides stable income with the company, is less important following the acquisition of the PV project. The company is going to report a net loss in 2009 due to an impairment loss of $9bn in goodwill arising from the acquisition. Such impairment loss will not have any effect on the cash flow of the company. We forecast the net profit will reach RMB2,614m and RMB3,163m in 2010 and 2011 respectively, underpinned by the contributions of the PV projects.

Gearing ratio is falling sharply - Like other power companies in China, GCL-Poly had a high gearing ratio in the past but we believe the net gearing ratio will fall to less than 10% between 2009-11F from over 100% previously due to: 1) robust operating cash inflow from the new poly-silicon and wafer businesses and 2) a total of $9.0bn cash inflow from financing on two share placements this year.

Sensitivity analysis - Since the price of poly-silicon is a key factor to the earnings of GCL-Poly, we have made a sensitivity analysis to determine the impact of a change in the poly-silicon price.

Leverage of poly-silicon price in 2010			base case		
Poly-silicon price (USD/kg)	55	50	46.4	45	40
Net profit (RMB m)	3422	2952	2614	2483	2013
2010 PER (x)	10.5	12.2	13.7	14.5	17.9

The reduction of unit cost of poly-silicon is mainly attributed by raising the output. Here shows the relationship between the change in output and the unit cost and the gross profit margin.

Leverage in poly silicon production					
Poly-silicon output (MT)	17000	15000	13000	11000	9000
Unit cost (US$/kg)	30.06	31.16	32.59	34.55	37.37
Gross profit margin	45%	44%	41%	37%	32%

Valuation and recommendation

GCL-Poly is now trading at 13.7x PER for 2010. As there is no other company doing similar business in the Hong Kong stock market, we decide to compare the company with the Big Seven.

Company	Country	2010 EPS	Share price	2010 PER (x)
REC	Norway	NOK1.973	NOK35.11	17.8
Wack	Germany	EUR7.792	EUR108.85	14.0
MEMC	US	USD0.87	USD12.06	13.8
Tokuyama*	Japan	JPY26.263	JPY478	18.2
Mitsubishi Materials*	Japan	JPY6.482	JPY201	31.0
Average				**19.0**

* Year-ended 31 March 2011

Source: Bloomberg

Excluding Mitsubishi Materials which has an exceptional high PER rating, the average 2010 PER is 15.9x. It implies that GCL-Poly is trading at a discount. Moreover, we have found that there is a China premium in the solar sector, which is evidenced by the fact that PRC solar companies listed in the US market are trading at a higher PER.

Company	2010 EPS (USD)	Share price (USD)	2010 PER (x)
Suntech	0.684	14.18	20.7
YGE	0.721	13.37	18.5
LDK	0.367	7.61	20.7
JA Solar	0.241	3.83	15.9
Average			**19.0**

Source: Bloomberg

In sum, we value GCL-Poly at HKD3.45 per share based on 18x PER for 2010. As there is a 30.7% upside potential from the current level, we initiate coverage with a BUY rating.

Company introduction

GCL-Poly has been engaged in the operation of cogeneration plant since 1996. The company manages 19 cogeneration power plants in Zhejiang and Jiangsu in China at present, providing electricity and steam for industrial estates nearby and trading coal as well. The revenue of the cogeneration power plants is stable with operation margin of around 13%. After acquiring the entire interest of Jiangsu Zhongneng, the company has extended its business into the PV industry. Jiangsu Zhongneng, now renamed as GCL solar, is the largest poly-silicon manufacturer in China and also the third largest in the world with an annual capacity of 18,000MT. The company is further integrating its solar project to midstream and downstream by producing wafers and building solar farms.

The company has several features worth to notice:

- It has experience of competing with state-owned enterprises as the electricity industry is dominated by SOE.
- It is keen on construction which is an advantage in capacity expansion. The management told us that their workers were in three-shift with strong experience in building power plants.
- It concentrates on green energy, therefore its cogeneration plants will not be affected by greenhouse gases reduction policy in future.

Risk Factors

Overseas regulatory risk – Change in policy will cause a reduction of demand like what happened in Spain and Germany in 2009. Also, the possibility of antidumping and trading dispute may increase as the Democratic Party is in administration in the US.

Domestic regulatory risk – The PRC government has no conclusion on the on-grid price of solar energy and the total subsidy amount of the Golden Sun Plan is 625MW only. Without government support, the demand of solar energy and related equipments will hardly pick up.

Competition from overseas players – We note that OCI of Korea is also ramping up its output aggressively with better quality. The company will face competition from OCI in the regional market.

Income statement (Year ended December 31)

RMB m	2007	2008	2009F	2010F	2011F
Turnover	**1,845**	**3,693**	**5,854**	**10,193**	**11,357**
Cost of sales	(1,482)	(3,196)	(4,793)	(7,185)	(7,835)
Gross profit	362	497	1,061	3,009	3,523
Other income	109	168	151	270	232
Distribution expenses	0	(7)	(7)	(7)	(7)
Administrative expenses	(143)	(213)	(309)	(356)	(376)
Other expenses	(67)	(24)	(9,000)	0	0
Operating profit	262	421	(7,661)	3,622	4,272
Finance costs	(162)	(259)	(227)	(495)	(423)
Share of associate profit	20	45	24	45	45
Loss on fair value of CN	(337)	0	0	0	0
Profit before tax	(216)	207	(7,865)	3,171	3,894
Tax	4	(27)	(14)	(507)	(681)
Minority interest	(55)	(48)	(50)	(50)	(50)
Net profit	**(267)**	**131**	**(7,929)**	**2,614**	**3,163**
EPS (RMB)	(0.571)	0.135	(1.297)	0.169	0.204
DPS ($)	0.000	0.023	0.025	0.038	0.046

Key ratios (Year ended December 31)

	2007	2008	2009F	2010F	2011F
Growth					
Turnover growth (%)	97.6	100.2	58.5	74.1	11.4
Net profit growth (%)	n.a.	n.a.	n.a.	n.a.	21.0
EPS growth (%)	n.a.	n.a.	n.a.	n.a.	21.0
DPS growth (%)	n.a.	n.a.	8.7	53.6	21.0
Profitability					
Gross profit margin (%)	19.6	13.5	18.1	29.5	31.0
EBITDA margin (%)	20.5	14.1	20.3	32.9	35.6
EBIT margin (%)	14.2	11.4	n.a.	35.5	37.6
Net profit margin (%)	n.a.	3.6	n.a.	25.6	27.8
Valuation					
PE (x)	n.a.	17.2	n.a.	13.7	11.4
EV/EBITDA (x)	90.8	65.9	29.0	10.3	8.5
PB ratio (x)	1.0	0.9	1.6	1.5	1.3
Dividend yield (%)	0.0	0.9	0.9	1.5	1.8
Return					
Return on equity (%)	n.a.	5.6	n.a.	11.2	12.3
Liquidity					
Net debt to equity (%)	107.1	107.8	0.4	7.0	3.6

Recommendation definitions:
BUY: Total return expected to be 10% or more in the next 12 months
HOLD: Total return expected to be between 0% and 10% in the next 12 months
SELL: Total return expected to be negative in the next 12 months

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