

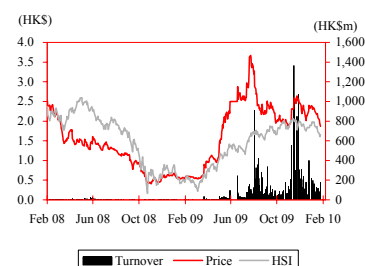
Trading Express
2 Feb. 2010
GCL-Poly Energy (3800.HK)

Buy: **HK\$1.84**
Target: **HK\$2.70**
Stop-loss: **HK\$1.65**

Highlights

- GCL-Poly Energy is a leading polysilicon producer in China. CIC has bought a 20.09% stake in the company for HK\$5.5bn to jointly develop solar-energy projects. Polysilicon production is expected to reach 21,000 MT this year.
- Polysilicon costs are US\$40/kg, with a gross margin of 35%. Costs may fall to US\$25-US\$35/kg following capacity expansion, while the gross margin should improve as polysilicon prices stabilize.
- The company plans to expand downstream: 1) its solar-energy power plant in Xuzhou is now complete, and 2) this month it acquired a 70.19% stake in Konca Solar for RMB854m. The outlook is bullish.
- The stock trades at a 10X FY10E P/E, a deep discount to its peers. Buy below HK\$1.85, targeting HK\$2.70, with stop-losses at HK\$1.65.

Performance (%)	1m	3m	12m
Absolute	(17.7)	(1.0)	260.4
Relative to HSI	(10.2)	5.3	203.0

GCL-Poly Energy – Price vs. HSI, Share Data


Price – HK\$	1.88
52W high/low (HK\$)	3.84/0.52
Shares in issue – millions	15,471.55
Market cap – HK\$m	29,550.66
3M avg. turnover – HK\$m	220.30
Major shareholder: (%)	
Asia Pacific Energy Fund	32.40

Sources: Bloomberg and Sun Hung Kai Financial

Figure 1: Earnings Summary

Year ending 31 Dec.	FY06	FY07	FY08	FY09E
Net profit – RMBm	58.3	(266.7)	131.3	(3,646.9)
Net-profit growth – %	115.5	N/A	N/A	N/A
EPS – RMB fen	15.0	(57.0)	14.0	(95.7)
EPS growth – %	117.4	N/A	N/A	N/A
P/E – X	12.3	N/A	13.1	N/A
DPS – RMB fen	N/A	0.0	2.0	1.0
Dividend yield – %	N/A	0.0	1.1	0.5
BVPS – RMB	313.4	2.3	2.5	1.1
P/B – X	0.0	0.8	0.7	1.8
Op. cash flow/share – RMB fen	39.6	29.4	43.6	(3.7)
Net debt (net cash)/ price – %	N/A	150.7	166.1	12.2

Sources: Bloomberg and Sun Hung Kai Financial
Note: Estimates are based on Bloomberg consensus

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Company Background

GCL Poly has transformed from a utility company focusing on power and steam generation into a global polysilicon producer, through the acquisition of GCL Solar Power, a leading supplier of polysilicon and wafers to the solar industry



Polysilicon is the primary raw material for wafers used in the solar and electronics industries. GCL's polysilicon has an average production cost of only about US\$40/kg, lower than many competitors. It is developing new production processes to further reduce costs.

After a dramatic collapse last year from 2008's peak of US\$450/kg, polysilicon prices have remained stable, with spot rates hovering between US\$50-US\$70/kg. A surge is unlikely after the previous build up in excess supply. Many of these new polysilicon plants have stopped production given the low prices. Those with low production costs, such as GCL, will prevail and take advantage of the current demand for cheap and affordable solar equipment and products.

In January, the company acquired a 70.19% stake in leading PRC solar-wafer supplier Konca Solar for RMB854m. This can help it expand its wafer business and further integrate down the solar value chain.



The stock trades at 10X FY10E earnings, a deep discount to the industry average of 19X. A re-rating could be imminent, as the solar division will become the main earnings driver from 2010.

Figure 2: GCL-Poly Energy – Investment Highlights

 Key investment positives	 Key investment negatives
<ul style="list-style-type: none"> ▪ Strategic holding by China Investment Corporation (CIC), which will buy 3.1 billion GCL new shares at HK\$1.79/share, becoming the second largest shareholder. The proceeds will help GCL pay down debt and increase working capital. ▪ Potential polysilicon market share of 20%. The acquisition of GCL Solar in July 2009 transformed GCL into one of China's largest polysilicon producers. The company had more than 18,000 MT of polysilicon production capacity by end-2009, which could account for as much as 20% of the polysilicon market. ▪ Rapid growth in polysilicon production. GCL's 3Q09 polysilicon production increased more than 250% yoy and 69% yoy to 1,993 MT. ▪ Bottoming polysilicon prices. After a dramatic decline throughout last year, polysilicon prices show signs of bottoming. Prices averaged about US\$61/kg in 4Q09, still a profit-making level for GCL. ▪ Low-cost polysilicon producer. GCL's average production costs are just US\$40/kg, lower than many competitors. ▪ Costs to decline further with success of its trichlorosilane (TCS) recycling technology. This can help cut costs from US\$40/kg to US\$30/kg by 2011, through higher manufacturing efficiency and lower electricity costs. ▪ Solar-power projects. GCL plans to build 100-200 MW of solar-farm capacity over the next two years, leveraging its extensive experience in the power sector. ▪ Stable utilities business. GCL's power-generation and steam businesses recorded stable growth of 13% and 2.4%, respectively for the first 10 months of 2009. These utilities will further benefit as China's economy continues to recover. ▪ Increasing ROE due to solar business. GCL's expansion into solar power/polysilicon will boost ROE (with the industry average at 15% vs. only 5% for utilities). ▪ Acquisition of Konca Solar, a leading wafer supplier in China. This will help GCL expand its wafer business and further integrate its solar business. Together with the completion of the Xuzhou plant, total wafer capacity will raised be 800 MW. 	<ul style="list-style-type: none"> ▪ Impairment loss on goodwill. GCL will record a HK\$9bn impairment loss in FY09 on goodwill from the acquisition of Jiangsu Zhongneng. ▪ Signs of inventory accumulation. GCL self-produced 1,993 MT of polysilicon in 3Q09, but sales volumes were estimated at only about 1,700MT. This implied sales shortfall could be a prelude to weakening demand in the polysilicon market. ▪ Many customers have in-house wafer production. GCL's current customers include Trina, Canadian Solar and JA Solar. These either have in-house or affiliated wafer-production capacity, reducing the need to purchase from GCL. ▪ Sharp rebound in polysilicon prices unlikely. Despite polysilicon prices showing signs of stability, there is still oversupply in the market, which should cap price increases. ▪ Lower-quality polysilicon. Most of GCL's current polysilicon production is of 6N+ quality, which generates lower ASPs than 9N+ products. The company aims to improve its polysilicon quality, but this should not be seen until late 2010.

Source: Sun Hung Kai Financial

Figure 3: GCL-Poly Energy – Upside/Downside Price Catalysts

 Upside price catalysts	 Downside price catalysts
<ul style="list-style-type: none"> ▪ Direct purchase of electricity from IPPs. If GCL could directly procure electricity from its own or third-party IPPs, this could lower electricity costs and boost profits. ▪ Improving polysilicon quality from 6N+ to 9N+ would boost ASPs and revenues. ▪ Divestiture of utility business. Selling the power and steam business can raise funds to pay down debt, and remove the drag on the company's ROE. ▪ Signing up more major customers. GCL's customers include Trina, Canadian Solar and JA Solar. But these already have in-house wafer-making capacity. 	<ul style="list-style-type: none"> ▪ Further decline in polysilicon prices. Currently, polysilicon prices are hovering around US\$60/kg. Continual declines to near production cost levels would decrease ASPs, shrink margins and hit earnings. ▪ Further share issues to reduce debt. ▪ Inability to sell all its products.

Source: Sun Hung Kai Financial

Industry Dynamics

China is the world's largest producer of photovoltaic cells, with 98% of PV-product sales exported. The credit crunch led to widespread cancellations of PV-product orders, particularly from the three largest consumers of Chinese solar-power products: Spain, Germany and Japan.

This contraction in demand has caused global PV solar-power-equipment prices to slump, such as PV wafers dropping 50% from RMB47-RMB48/wafer to as low as RMB26/wafer. In turn, this has created a supply glut in the PRC PV solar-power-equipment industry.

This means a difficult business environment for upstream equipment makers, but downstream consumers benefit from lower equipment costs. Industry fundamentals are becoming further supportive of downstream solar-power businesses, such as building integrated photovoltaic (BIPV) systems, due to increasing government support.

The Chinese government's green initiatives give solar power a key role in easing its reliance on fossil fuels and reducing pollution. Recent environmentally friendly policies to ensure sustainable development include:

- *The Renewable Energy Medium, Long Term Development Plan* calls for a 22-fold increase (20% CAGR) in total solar-power capacity (from the current 80 MW to 300 MW in 2010 and 1,800 MW by 2020). By 2020, a total of 20,000 PV-equipped rooftops with 1,000 MW total electricity output capacity will be developed.
- *Interim Measures for the Administration of Government Subsidies of Building Uses of Solar Energy Photovoltaic Power* provides an RMB15-RMB20/Wp subsidy for integrating PV solar-power facilities of at least 50 kW into buildings. This would reduce the installation cost of such a system by about half.
- *Golden Sun Program* provides a 50% subsidy for investment in solar-power projects as well as relevant power transmission and distribution systems.

Various reports have stated that China may further increase its solar-power electricity-production capacity to 10 GW by 2020. Despite current government policies supporting solar power, more is needed to reach this target. The mainland may follow in the path of countries such as Germany in providing further support to develop the solar-power industry, such as feed-in-tariffs where solar-energy users would be paid for the solar power they produce.

China's solar-power-integration program will be driven by its downstream solar-power industry, which should continue to outperform upstream equipment producers as they wait for production glut to slowly ease.

Figure 4: GCL-Poly Energy – Profit and Loss Statement

Year ending 31 Dec., RMBm	FY05	FY06	FY07	FY08	FY05-08 CAGR (%)
Revenue	822.8	910.0	1,844.7	3,693.3	70.4
COGS	(675.8)	(710.8)	(1,482.2)	(3,196.0)	72.0
Gross Profit	147.0	199.3	362.4	497.3	61.5
Operating expenses	(52.1)	(65.0)	(197.4)	(225.3)	57.6
Other operating income	22.5	28.2	72.4	147.8	76.2
Operating profit	117.4	162.5	237.5	419.8	68.6
Finance expenses	(68.3)	(87.1)	(161.5)	(258.7)	67.8
PBT	52.6	89.2	(215.8)	206.9	80.6
Tax	0.2	(3.5)	4.0	(27.1)	N/A
Net profit	27.0	58.3	(266.7)	131.3	127.5
EPS – RMB fen	6.9	15.0	(57.0)	14.0	74.8

Sources: The Company and Sun Hung Kai Financial

Figure 5: GCL-Poly Energy – Profit and Loss Statement (Year on Year Growth)

Year ending 31 Dec., %	FY05	FY06	FY07	FY08	FY05-08 CAGR
Revenue	87.7	10.6	102.7	100.2	70.4
COGS	85.0	5.2	108.5	115.6	72.0
Gross Profit	101.0	35.5	81.9	37.2	61.5
Operating expenses	42.6	24.6	203.9	14.2	57.6
Other operating income	47.1	25.1	156.8	104.1	76.2
Operating profit	126.3	38.4	46.1	76.8	68.6
Finance expenses	109.3	27.5	85.4	60.2	67.8
PBT	170.8	69.4	N/A	N/A	N/A
Tax	(49.6)	(1,856.3)	(216.4)	(774.0)	N/A
Net profit	452.0	115.5	N/A	N/A	N/A
EPS	360.0	117.4	N/A	N/A	N/A

Sources: The Company and Sun Hung Kai Financial

Figure 6: GCL-Poly Energy – Profit and Loss Statement (Common Size)

Year ending 31 Dec., %	FY05	FY06	FY07	FY08	FY05-08 Average
Revenue	100.0	100.0	100.0	100.0	100.0
COGS	(82.1)	(78.1)	(80.4)	(86.5)	(81.8)
Gross Profit	17.9	21.9	19.6	13.5	18.2
Operating expenses	(6.3)	(7.1)	(10.7)	(6.1)	(7.6)
Other operating income	2.7	3.1	3.9	4.0	3.4
Operating profit	14.3	17.9	12.9	11.4	14.1
Finance expenses	(8.3)	(9.6)	(8.8)	(7.0)	(8.4)
PBT	6.4	9.8	(11.7)	5.6	2.5
Tax	0.0	(0.4)	0.2	(0.7)	(0.2)
Net profit	3.3	6.4	(14.5)	3.6	(0.3)

Sources: The Company and Sun Hung Kai Financial

Figure 7: GCL-Poly Energy – Balance Sheet

As at 31 Dec., RMBm	FY05	FY06	FY07	FY08	FY05-08 CAGR (%)
Cash and securities	95.7	186.6	804.0	413.7	30.3
Accounts receivable	103.7	111.0	380.5	366.0	46.7
Inventory	36.9	42.0	126.0	258.8	72.8
Other current assets	241.3	231.9	437.1	368.8	9.7
Total current assets	477.6	571.4	1,747.6	1,407.4	29.1
Net fixed assets	2,070.9	2,294.5	4,891.7	5,176.2	33.7
Other long-term assets	33.7	481.6	227.5	485.9	126.8
Total assets	2,582.2	3,347.5	6,866.8	7,069.5	34.7
Short-term debt	387.5	426.3	1,511.6	1,788.5	69.6
Accounts payable	32.9	39.3	139.3	109.6	39.6
Other current liabilities	429.8	428.7	506.4	643.9	25.3
Total current liabilities	850.1	894.4	2,157.3	2,542.0	49.7
Long-term debt	1,069.3	1,923.8	1,988.0	1,597.2	12.4
Other long-term liabilities	3.7	9.9	84.7	106.6	143.2
Total liabilities	1,923.1	2,828.1	4,230.0	4,245.8	29.4
Shareholders equity	659.0	519.4	2,636.9	2,823.7	45.2
Minorities	184.8	206.0	364.1	408.0	23.4
Total equity and liabilities	2,582.2	3,347.5	6,866.8	7,069.5	34.7

Sources: The Company and Sun Hung Kai Financial

Figure 8: GCL-Poly Energy – Balance Sheet (Common Size)

As at 31 Dec., %	FY05	FY06	FY07	FY08	FY05-08 CAGR (%)
Total assets					
Cash and securities	3.7	5.6	11.7	5.9	6.7
Accounts receivable	4.0	3.3	5.5	5.2	4.5
Inventory	1.4	1.3	1.8	3.7	2.0
Other current assets	9.3	6.9	6.4	5.2	7.0
Total current assets	18.5	17.1	25.5	19.9	20.2
Net fixed assets	80.2	68.5	71.2	73.2	73.3
Other long-term assets	1.3	14.4	3.3	6.9	6.5
Total assets	100.0	100.0	100.0	100.0	100.0
Total equity and liabilities					
Short-term debt	15.0	12.7	22.0	25.3	18.8
Accounts payable	1.3	1.2	2.0	1.6	1.5
Other current liabilities	16.6	12.8	7.4	9.1	11.5
Total current liabilities	32.9	26.7	31.4	36.0	31.8
Long-term debt	41.4	57.5	29.0	22.6	37.6
Other long-term liabilities	0.1	0.3	1.2	1.5	0.8
Total liabilities	74.5	84.5	61.6	60.1	70.2
Shareholders equity	25.5	15.5	38.4	39.9	29.8
Minorities	7.2	6.2	5.3	5.8	6.1
Total equity and liabilities	100.0	100.0	100.0	100.0	100.0

Sources: The Company and Sun Hung Kai Financial

Figure 9: GCL-Poly Energy – Key Ratios

Year ending 31 Dec.	FY05	FY06	FY07	FY08	FY05-08 average
Profitability ratios					
Gross margin – %	17.9	21.9	19.6	13.5	18.2
Operating margin – %	14.3	17.9	12.9	11.4	14.1
Net margin – %	3.3	6.4	(14.5)	3.6	(0.3)
ROAA – %	1.1	2.0	(5.2)	1.9	(0.1)
ROAE – %	4.2	9.9	(16.9)	4.8	0.5
Liquidity ratios					
Current assets / current liabilities – X	0.6	0.6	0.8	0.6	0.6
Liquid assets / current liabilities – X	0.1	0.2	0.4	0.2	0.2
Cash and securities / current assets – %	20.0	32.6	46.0	29.4	32.0
Cash flow from oper. / curr. liabilities – %	17.9	17.2	6.4	16.7	14.5
Other ratios					
Capex / sales – %	58.8	32.4	14.3	9.1	28.7
Capex / depreciation – %	619.9	311.5	162.3	132.8	202.2
Operating expenses / sales – %	(6.3)	(7.1)	(10.7)	(6.1)	(8.0)
Net debt (cash) / equity – %	206.5	416.5	102.2	105.2	208.0
Inventory / sales – %	4.5	4.6	6.8	7.0	6.1
Effective tax rate – %	(0.4)	3.9	1.9	13.1	6.3
Cash-conversion cycle – days	41.9	44.9	48.5	45.3	46.2
ROAA component analysis					
Revenue / average assets – %	34.8	30.7	36.1	53.0	38.7
COGS / average assets – %	(28.6)	(24.0)	(29.0)	(45.9)	(31.9)
Gross profit / average assets – %	6.2	6.7	7.1	7.1	6.8
Operating expenses / average assets – %	(2.2)	(2.2)	(3.9)	(3.2)	(2.9)
Other operating income / average assets – %	1.0	1.0	1.4	2.1	1.4
Operating profit / average assets – %	5.0	5.5	4.7	6.0	5.3
Finance expenses / average assets – %	(2.9)	(2.9)	(3.2)	(3.7)	(3.2)
PBT / average assets – %	2.2	3.0	(4.2)	3.0	1.0
Tax / average assets – %	0.0	(0.1)	0.1	(0.4)	(0.1)
Net profit / average assets – %	1.1	2.0	(5.2)	1.9	(0.1)
ROAE component analysis					
Revenue / average equity – %	127.2	154.4	116.9	135.3	133.5
COGS / average equity – %	(104.5)	(120.6)	(93.9)	(117.1)	(109.0)
Gross profit / average equity – %	22.7	33.8	23.0	18.2	24.4
Operating expenses / average equity – %	(8.1)	(11.0)	(12.5)	(8.3)	(10.0)
Other operating income / average equity – %	3.5	4.8	4.6	5.4	4.6
Operating profit / average equity – %	18.2	27.6	15.0	15.4	19.0
Finance expenses / average equity – %	(10.6)	(14.8)	(10.2)	(9.5)	(11.3)
PBT / average equity – %	8.1	15.1	(13.7)	7.6	4.3
Tax / average equity – %	0.0	(0.6)	0.3	(1.0)	(0.3)
Net profit / average equity – %	4.2	9.9	(16.9)	4.8	0.5

Sources: The Company and Sun Hung Kai Financial

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