China Oriental(581.HK) Earnings beating expectation; showing strong valuations

Company Report | Rating: **LT-Buy↑** | Price: **HK$2.70** | TP: **HK$3.5↑** | Upside: **29.6%**

11 August 2010

Event:
Review on 2010 interim results.

Stock data (HK$)

52w High (HK$)	3.50
52w Low (HK$)	1.80
Market cap (HK$m)	7,940
No of shares (m)	2,930
Avg daily vol (m)	2.26
1-mth change（%）	27.23
YTD change（%）	-2.87
50d MA	2.19
200d MA	2.62
14-day RSI	64.84

Source: Bloomberg

1-yr share price:

Source: Bloomberg

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Summary:

- **1H10 earnings better-than-expected.** The Company's interim results revealed that its revenue grew 67.3% YoY to RMB15.35bn while net profit attributable to ordinary shareholders soared 122.9% YoY to RMB798m. EPS jumped 125% YoY to RMB0.27. Earnings in 1H10 represented 90% of the profits in 2009, indicating a market-beating recovery.

- **Rapid expansion in production capacity and recovery in gross margins were the key for the strong results.** The Company saw rapid expansion in production capacity in 1H10 following the full operation of the production assets it acquired and leased. Its current overall production capacity of crude stell reached 11m tonnes per annum. Sales of steel products grew 40.1% YoY to 4.47m tons. Meanwhile, gross margins continued to improve with the recovery in steel prices. Gross profit per tonne of the Company's products increased to RMB313 in 1H10, reflecting a YoY increase of 33.2%. Gross profit margin increased to 9%, up 10% YoY.

- **Stabilizing profit level.** The Company is principally engaged in the production of hot rolled steel strips for construction use and H-section steel. In 1H, the Company sold a total of 1.772m tons of hot-rolled steel strips and 1.481m tons of H-section steel, representing 39.64% and 33.13% of its total sales respectively. H-section steel, one of the key products of the Company, saw stable growth in output since 2006. As compared with most of the steel categories in China, H-section steel has a higher production concentration level with moderate market competitions among several enterprises such as Maanshan Iron, Laiwu Steel and Rizhao Steel. Despite volatile steel price in 1H, profit level is stabilizing. Also, it has strong cost control and management capability. Expenses dropped to less than 2% of its revenue in 1H.

- **We uplift our rating to "LT-Buy" given attractive valuation.** The Company has reached production capacity of 11.0m tons. With a stabilizing profit level, we expect 2010-12 EPS to reach RMB0.42, RMB0.46 and RMB0.49 respectively. Valuation is very attractive given less than 10x PE and less than 1x PB. We uplift our rating to "LT-Buy" and assign a TP of HK$3.5.

Valuations

	FY07	FY08	FY09	FY10F	FY11F
Revenue（RMB m）	13,499	19,388	20,589	28,446	32,196
YoY Growth（%）	38.0	43.6	6.2	38.2	13.2
Net profit（RMB m）	1,160	44	884	1,238	1,352
YoY Growth（%）	12.3	-96.2	-	40.0	9.2
EPS（RMB）	0.40	0.02	0.30	0.42	0.46
PE			7.8	5.6	5.1
NAPS（RMB）	0.0	0.0	2.5	2.9	3.3
PB			0.9	0.8	0.7

Source: Company, BOCOM Int'l

1. A leading privately-owned iron & steel enterprise

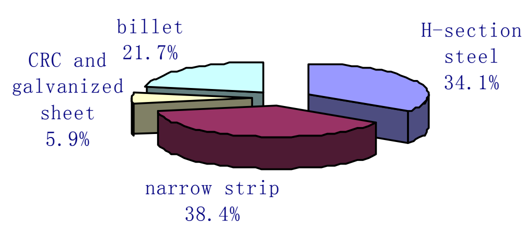
China Oriental Group is a leading privately-owned iron & steel enterprise in China with an annual production capacity of crude steel of 11m tonnes. While its core products are hot-rolled steel strips and H-section steels, it has been exploring into other processing products such as cold-rolled sheets and galvanized sheets. We expect the sales of its steel products (including steel billet) could reach 8.4m tonnes in 2010, representing a YoY increase of 20.8%.

Chart 1: The Company's sales of steel products in recent years (Unit: 1000 tonnes)

	2007	2008	2009	2010H1	2010F
Hot rolled steel stripes	2451	2061	2861	1772	3300
H-section steel	1205	1225	2460	1481	2800
Billets	299	1007	134	1015	1900
Cold rolled sheets and galvanized sheets	173	241	286	202	400
Total	4128	4534	6948	4470	8400

Source: Company, BOCOM Int'l

Chart 2: Revenue breakdown



Source: Company, BOCOM Int'l

H-section steel is one of the key products of the Company recently. With an annual production capacity of 3m tonnes, China Oriental Group ranked top in the country's H-section steel market. Designated production capacity of large scale H-section steels is approximately 1.2m tonnes, accounting for a market share of 21.4%. Compared with other products, large scale H-section steels does not see fierce competitions. In addition, the demand for H-section steels is expected to grow rapidly given the fast development of China's construction steel market. Meanwhile, the product possessed the highest profit margin among all products of the Company in all years except 2009.

Chart 3: Changein gross margin of the Company's steel products (Unit: RMB/tonne)

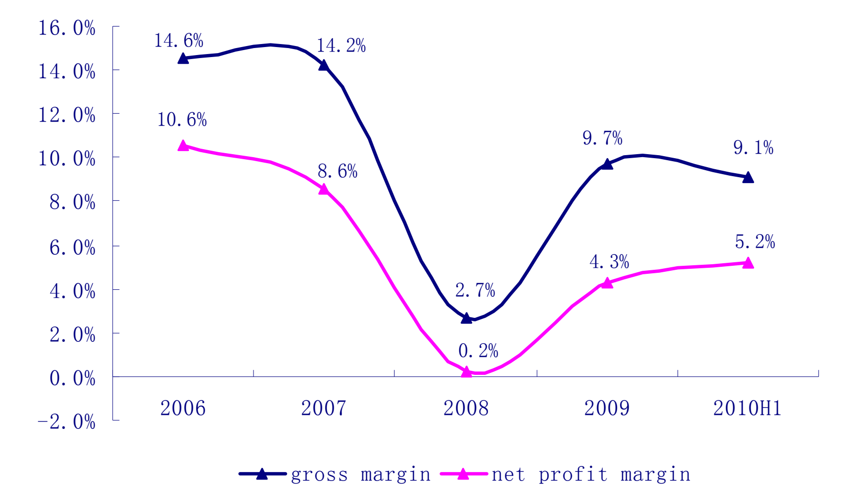
	2007	2008	2009	2010H1	2010F
H-section steel	668	252	285	417	3300
Hot-rolled steel strip	404	99	342	301	2800
Cold-rolled sheets and galvanized sheets	198	49	2	228	1900
Billets	281	-10	242	197	400
Average	464	114	289	313	464

Source: Company, BOCOM Int'l

2. Outstanding earnings

As a large privately-owned iron & steel enterprises, its effective cost control measure, which guarantees a lower production cost, is the key for its outstanding earnings. The Company's gross margins and net profit margins have been higher than the industry average since 2006, despite a huge plunged observed in 2008 due to the global financial crisis. Compared to other domestic iron & steel enterprises listed in HK, the Company's earnings in 2009 were significantly at a higher position.

Chart 4: Change in GM% and NM% since 2004



Source: Company, BOCOM Int'l

Chart 5: Comparison of profit level among HK-listed iron and steel companies in 2009

	Company	Ansteel	Maanshan Iron	Chongqing Iron
GM%	9.74%	6.19%	5.43%	10.99%
NM%	4.30%	1.07%	0.78%	0.80%

Source: BOCOM Int'l

Chart 6: Comparison of management expenses among HK-listed iron and steel companies in 2009

	Management expenses as a percentage of revenue	Sales expenses as a percentage of revenue
Company	1.4%	0.3%
Ansteel（0347.HK）	3.1%	0.7%
Maanshan Iron（0323.HK）	2.3%	0.9%
Chongqing Iron（1053.HK）	5.2%	2.7%

Source: BOCOM Int'l

3. Introduction of ArcelorMittal improves corporate governance

Being the second largest shareholder of the Company, ArcelorMittal is the world's largest steel corporation and owns 29.62% interest in the Company. Apart from effectively improving corporate governance, the introduction of ArcelorMittal as a shareholder will enable the Company to fully enjoy the extensive global iron ore purchasing and steel marketing network of the ArcelorMittal Group. The Company has been included in the global business development plan of ArcelorMittal Group. Also, the Company serves as an important platform for expanding the steel business of ArcelorMittal Group in China. We believe the introduction of ArcelorMittal as a shareholder enhances the M&LT growth potential of the Company effectively.

Chart 7: Profit forecast (Unit: RMB m)

	2010F	2011F	2012F
Sales revenue	28,446	32,196	34,652
Gross profit	2,467	2,726	2,906
Net profit attributable to ordinary shareholders	1,237.8	1,352.0	1,442.0
EPS（RMB/share）	0.42	0.46	0.49

Source: BOCOM Int'l

We expect steel output (including billets) to grow steadily to over 10m tons in the next three years. Despite possible slowdown in output growth, profit will remain stable given good cost control of the Company. EPS may reach RMB0.42, RMB0.46 and RMB0.49 respectively. We assign a TP of HK$3.5 amid a low valuation.

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Rating System
Company Rating
Buy: Expect more than 20% upside in 12 months
LT Buy: Expect more than 20% upside but longer than 12 months
Neutral: Expect low volatility
Sell: Expect more than 20% downside in 12 months

Sector Rating
Outperform: Expect more than 10% upside in 12 months
Market perform: Expect low volatility
Underperform: Expect more than 10% downside in 12 months

Analyst Certification

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