


STEEL

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Company Update

Private Circulation Only

China Oriental Group Co Ltd (581.HK)

BUY **Maintain**
Price **HKD2.90**
Target **HKD4.25**
 (from HKD4.25)

Robust Sentiments...
Stock Profile/Statistics

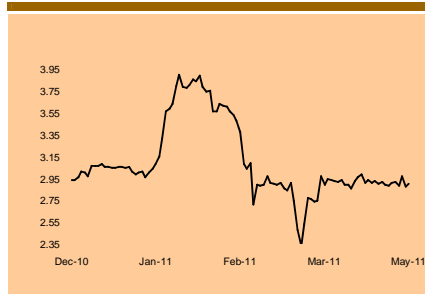
Bloomberg ticker	581 HK Equity
Hang Seng Index	23,336.00
Issued share capital (m)	2,929.73
Market capitalization (HK\$m)	8,496.20
52 week H L price (HK\$)	4.11
Average volume (3m) '000	356.42
YTD returns	-8.52
Net gearing (x)	0.59
Altman Z-Score	2.85
ROCE/WACC	1.17
Beta (x)	0.83
Book value/share (RMB)	2.75

Major Shareholders (%)

Mr HanJingyuan	45.1
ArcelorMittal	29.6
Deutsche Bank & ING Bank	17.4

Share Performance (%)

Month	Absolute	Relative
1m	-2.3	1.1
3m	-26.2	-26.2
6m	-2.9	-0.6
12m	3.5	-16.6

12-month Share Price Performance


We brought a group of investors to visit China Oriental integrated steel plant in Qianxi, Hebei Province recently. Management appears to be positive on the outlook, in particular for 1HFY11, following the escalating selling price and firm demand toward long steel products. The company is also on the active lookout on possible M&As at attractive prices following the huge amount of cash raised from Senior Notes issuance. Together with the bullish biased operating number released to HKSE last week, we reiterate our BUY recommendation on China Oriental with our fair value maintained at HKD4.25.

Visit to Qianxi. We brought a group of twenty, comprising primarily fund managers and analysts of asset management companies from Malaysia and Singapore, for "A Close-Up on China" visit recently. Our first visit was to China Oriental's Jinxi production site situated at Qianxi, Tangshan city, Hebei Province at the end of last month. After an almost four hour journey, passing through the heavy morning traffic at Beijing Capital, then less developed second to third tier cities, we finally arrived at Qianxi. Our official visit began with a quick video overview and presentation by Mr. Muktesh Mukherjee, ED of China Oriental cum chief representative of Arcelor Mittal in China. Mr. Zhu Jun, ED cum COO of China Oriental then took questions from investors. After more than an hour of intensive discussion, we visited the 7m tonne integrated steelmaking capacity in Jinxi Production site, including the Blast Furnace (BF) control room, sintering plant, and heavy section rolling mill.

Encouraging sentiments. The questions to management were centred on the market prospects of the steel industry especially with prices and demand seen weakening post the Lunar Calendar New Year in February 2011. Nonetheless, management believes demand of steel, in particular long steel products, remains strong given that China's economy still driven by government capital investment. Mr. Zhu also explained that the current weakness in prices for May 2011 is mainly on flat steel products, while most of the long steel product prices remain firm. Furthermore, China Oriental told HKSE last Friday that its total sales of steel products of the group for 1QFY11 were RMB9.6bn, an increase of 44.8% y-o-y. Other than sales volumes of various steel products that increased ranging from 10.8% to 57.1%, revenue was also boosted by higher average selling prices of their products that rose between 15.3% to 23.6%.

FYE Dec (RMBm)	2008A	2009A	2010A	2011F	2012F
Total Revenue	19,388.2	20,589.1	30,135.7	35,340.8	36,231.1
Core Net Profit	44.0	884.3	1,062.8	1,501.6	1,645.0
% chg YoY	-96.2	1,908.4	20.2	41.3	9.5
Consensus Net Profit	-	-	-	1,412.7	1,540.5
Core EPS (sen)	0.015	0.302	0.363	0.513	0.561
Gross DPS (sen)	0.057	0.076	0.091	0.152	0.140
Gross Div. Yield (%)	2.2	3.0	3.7	6.5	6.0
PER (x)	169.7	8.5	6.8	4.6	4.2
P/BV (x)	1.2	1.0	0.9	0.8	0.7
EV/EBITDA (x)	12.3	4.4	4.7	2.9	2.3
ROE (%)	0.7	13.2	13.9	17.5	16.9
ROA (%)	0.4	6.0	5.9	6.6	6.5

Success story in H-section steel. China Oriental is the market leader in medium and large H-sections, with a market share of 28.5% in 2009. The company has introduced new products and established direct sales channels to improve margins. Given the bright prospects from the growing emphasis on structural safety and modern buildings plus the current low usage of H-sections at only 1% of total steel usage in China, investors also questioned on this product segment. The company produces H-sections with cross-sectional dimensions ranging from 100x100mm to 900x300mm. As the company was only the third player to enter into H-section steel after Magang and Laigang, its achievement of 25% to 30% market share is impressive. Mr. Zhu believes China Oriental's widest product range and biggest capacity of 3.5m tonne per year (tpy) from its three production lines offers the necessary competitive edge. The tie-up with its second largest shareholder, Arcelor Mittal also enables the company to enjoy technical support on this product.

Exhibit 1: Group photo taken with China Oriental management



Source: OSK

On the acquisition mode. The management explained that the issuance of USD850m Senior Notes not only helped to part refinance the company's existing borrowings totalling USD300m, but also provided funding for potential new investments. Among others, China Oriental is on the lookout for acquisition targets given its proven record in integrating the steel business. It is also targeting to introduce new products comprising steel sheet piles as well as high speed wire rods to complete its long steel product range, and to phase out the selling of semi-finished steel. As for the acquisition, Mr. Zhu assured investors that management will only consider M&A targets that offer attractive returns based on a low asking price. He also said, China Oriental management has implemented a policy to invest in various first class machinery for the important processes but saves cost on those less important processes. A key example will be the company continues to use manual processes where economical given that labour cost remains cheap in China.

Financial Summary (FYE 31 December)

Valuation and Growth						Financial Ratios					
	2008A	2009A	2010A	2011F	2012F		2008A	2009A	2010A	2011F	2012F
Valuation Ratios						Profitability Ratios					
PER (Basic) (x)	169.7	8.5	6.8	4.6	4.2	Gross margin	5.8	14.0	10.2	10.6	11.0
Dividend yield	2.2	3.0	3.7	6.5	6.0	EBITDA margin	4.0	11.2	9.0	8.9	9.3
P/BV (x)	1.2	1.0	0.9	0.8	0.7	Core net margin	0.2	4.3	3.5	4.2	4.5
Growth						Balance Sheet Ratios					
Revenue (%)	43.6	6.2	46.4	17.3	2.5	Current ratio	0.9	1.0	2.0	1.2	1.2
EBITDA (%)	-60.5	195.9	17.6	16.1	7.2	Gross debt/equity	0.3	0.4	0.8	0.6	0.5
Core Net profit (%)	-96.2	1908.4	20.2	41.3	9.5	Net debt/equity	0.2	0.2	0.5	0.1	-0.1
Per Share Data						Inventory Days					
(RMB)	2008A	2009A	2010A	2011F	2012F	Receivable Days	31.3	53.6	55.1	53.6	53.6
EPS (Basic)	0.015	0.302	0.363	0.513	0.561	Payable Days	32.6	21.2	42.7	36.5	36.5
DPS	0.057	0.076	0.091	0.152	0.140		44.3	35.6	22.7	34.2	34.2
Payout ratio	380.3	25.1	25.0	25.0	25.0	Balance Sheet					
BV/S	2.14	2.45	2.75	3.12	3.54	(RMBm)	2008A	2009A	2010A	2011F	2012F
Income Statement						Fixed Asset					
(RMBm)	2008A	2009A	2010A	2011F	2012F	Property, plant & equipments	8,286.8	8,625.6	7,946.5	7,764.9	7,545.8
Total revenue	19,388.2	20,589.1	30,135.7	35,340.8	36,231.1	Investment	28.5	27.9	27.3	27.5	27.7
Cost of sales	-18,273.2	-17,699.8	-27,065.7	-31,600.2	-32,250.5	Intangible assets	7.7	0.0	0.0	0.0	0.0
Gross profit	1,115.0	2,889.3	3,070.0	3,740.5	3,980.6	Others	400.4	154.1	599.8	599.8	599.8
Selling & distribution costs	-80.3	-57.0	-65.7	-106.0	-108.7	Total fixed assets	8,723.3	8,807.6	8,573.7	8,392.3	8,173.3
General and administrative	-281.9	-283.5	-301.1	-530.1	-543.5	Current Asset					
Operating profit/expenses	24.0	-250.6	0.3	35.3	36.2	Cash and cash equivalents	728.8	644.0	2,223.2	4,498.0	5,929.8
EBITDA	776.7	2,298.2	2,703.6	3,139.7	3,364.6	Amount due from related cos	1,567.4	2,598.0	4,085.7	4,642.4	4,737.9
Depreciation & amortisation	-573.5	-847.5	-894.7	-681.6	-719.1	Inventories	1,734.0	1,197.1	3,524.4	3,529.8	3,618.7
Finance costs	-91.6	-137.1	-195.7	-406.8	-406.8	Trade receivables	1,382.5	1,942.4	2,334.9	3,431.1	3,481.3
Exceptional items	0.0	0.0	0.0	280.0	0.0	Others	5,412.7	6,381.5	12,168.4	16,101.3	17,767.8
Associate / JV's contribution	2.0	0.2	0.2	0.2	0.2	Total current assets					
Pre-tax profit	113.6	1,313.7	1,613.5	2,331.5	2,238.8	Current Liabilities	2,219.4	1,725.8	1,682.7	2,964.8	3,025.8
Taxation	-70.6	-341.3	-428.0	-512.8	-559.7	Trade payables	1,697.2	1,796.5	680.2	0.0	0.0
Minority interests	1.1	-88.1	-122.6	-37.1	-34.2	Short-term loans	0.0	0.0	0.0	0.0	0.0
Reported net profit	44.0	884.3	1,062.8	1,781.6	1,645.0	Amount due to related cos	2,264.5	2,798.5	3,696.5	6,210.2	6,328.8
Core net profit	44.0	884.3	1,062.8	1,501.6	1,645.0	Others	6,181.1	6,320.7	6,059.4	9,175.0	9,354.6
Cashflow Statement						Long-Term Liabilities					
(RMBm)	2008A	2009A	2010A	2011F	2012F	Borrowings	489.2	758.9	5,791.0	0.0	0.0
Operating cashflow						Others	0.0	0.0	0.0	5,319.9	5,319.9
Pre-tax profit	113.6	1,313.7	1,613.5	2,331.5	2,238.8	Others	975.7	648.8	371.8	371.8	371.8
Depreciation & amortisation	573.5	847.9	892.0	681.6	719.1	Total long term liabilities	1,465.0	1,407.7	6,162.9	5,691.7	5,691.7
Others	2,280.5	246.6	195.5	406.6	406.6	Shareholders' funds					
Change in working capital	-2,391.8	-2,140.7	-2,774.1	2,137.7	-55.1	Share Capital	311.7	311.7	311.7	311.7	311.7
Tax paid	-427.8	-16.0	-428.0	-512.8	-559.7	Reserves	5,953.6	6,857.1	7,758.0	8,828.0	10,061.7
Total operating cashflow	147.9	251.6	-501.2	5,044.6	2,749.8	Equity attributable to owner	6,265.2	7,168.8	8,069.8	9,139.7	10,373.4
Investing cashflow						Minority interests	224.7	292.0	450.0	487.1	521.3
Capex	-953.6	-930.9	-503.7	-500.0	-500.0						
Investments	-247.0	207.3	-43.1	0.0	0.0						
Others	-309.8	48.7	-1,204.2	0.0	0.0						
Total investing cashflow	-1,510.4	-674.8	-1,751.0	-500.0	-500.0						
Financing cashflow											
Equity raised	0.0	0.0	86.9	0.0	0.0						
Debt raised / paid	982.2	361.4	0.0	0.0	0.0						
Dividend paid	0.0	0.0	-195.7	-406.8	-406.8						
Others	427.5	-22.6	2,907.4	-725.4	-411.2						
Total financing cashflow	1,409.7	338.8	2,798.6	-1,132.2	-818.1						
Net cash inflow / (outflow)	47.2	-84.4	546.5	3,412.4	1,431.8						
Cash - beg	689.6	728.8	644.0	1,190.5	4,602.9						
Others	-8.0	-0.4	0.0	0.0	0.0						
Cash - end	728.8	644.0	1,190.5	4,602.9	6,034.7						

Source: Company data, OSK Securities Hong Kong Limited

OSK Research Guide to Investment Ratings

Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels

Sell: Share price may fall by more than 10% over the next 12 months

Not Rated: Stock is not within regular research coverage

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