

China Oriental

Risks should be largely priced in at current levels

Initiation
Overweight

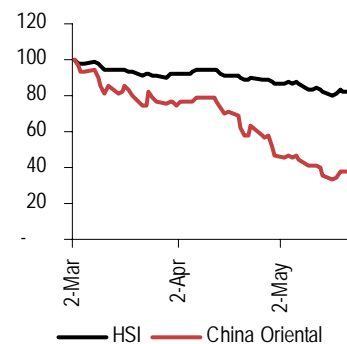
HK\$1.53
24 May 04

- We are initiating coverage of China Oriental with an Overweight rating with a 12-month implied fair value of HK\$1.75, based on our long term ROE versus PBR valuation, supported by our DCF analysis.
- Share price catalysts for a near-term upside remain elusive as the market continues to remain concerned about China's macro tightening and the US interest rate hikes.
- Since it was listed in Hong Kong on March 1, the stock has witnessed a 62% correction from its high price of HK\$3.40, and at current levels we believe risks are largely priced in.
- A positive product mix shift and likely volume growth in 2005 from entry into H-Beams should enable the company to achieve a positive earnings momentum at the OP level, although expected tax rate increase would depress 2005E EPS.

China
Metals & Mining

Henry Kwon
(82-2) 758-5732
henry.c.kwon@jpmorgan.com

Share price relative chart



Source: Datastream.

Reuters 0581.HK, Bloomberg 581

Rmb in millions, year-end December

	2001	2002	2003	2004E	2005E	52-week range
Sales	1,490	2,571	5,278	7,929	8,674	Market cap (LCY) HK\$4444.65MM
OP	245	604	1,167	1,618	1,782	Market cap (US\$) US\$570.56MM
EBITDA	322	675	1,263	1,766	1,966	Free float 28%
NP	154	388	1,076	1,486	1,408	AVG daily volume 29.3MM shrs
EPS	0.07	0.17	0.48	0.53	0.47	Hang Seng 1,497.3
BPS	0.11	0.15	0.42	0.77	1.11	HK\$/US\$ 7.79
DPS	0.08	0.17	0.21	0.10	0.09	Rmb/US\$ 8.28
ROE	62%	115%	114%	68%	42%	
P/E	22.1	8.8	3.2	2.9	3.3	ADR/GDR
P/B	13.7	10.1	3.6	2.0	1.4	Reuters NM
EV/EBITDA	11.8	6.2	3.7	3.3	2.6	Bloomberg NM
Dividend yield	5%	11%	14%	6%	6%	ADR/GDR price NM
Performance			1mth	3mths	12 mths	52-week range NM
Absolute (%)			-33.8	NM	NM	Ratio NM
Relative (%)			-28.7	NM	NM	AVG daily volume NM

Source: Company reports and JPMorgan estimates.

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Table of Contents

Valuations and Rating	3
Investment thesis	4
Investment Positives	4
Investment Risks	5
Industry fundamentals	6
Secular vs. cyclical issues	6
Long product pricing dynamics	7
H-beams: a classic case of steel commoditization?	8
Company Description	9
Earnings Outlook	11

Tables

Table 1: China Oriental—PBR versus ROE valuation	3
Table 2: China: Elasticity of IP & FAI growth to GDP growth	5
Table 3: Sensitivity of COG's earnings to H-beam production & sales, 2005E	5
Table 4: China—Billet price sensitivity to fixed asset investment growth & total steel supply growth, 2004E	7
Table 5: China—Long product price outlook	8
Table 6: China—Historical H-beam supply & demand	8
Table 7: China—Published plans for H-beam capacity additions	9
Table 8: China Oriental—Details of planned investments	11
Table 9: China Oriental—Sales forecast	12
Table 10: China Oriental—Raw material cost breakdown	14
Table 11: China Oriental—Consolidated income statement	15
Table 12: China Oriental—Consolidated balance sheet	16
Table 13: China Oriental—Consolidated cash flow statement	17

Figures

Figure 1: China—Annual Fixed Asset Investment growth vs. average annual billet price changes, 1996-2003	6
Figure 2: China—Annual average billet price changes vs. HRC price changes	7
Figure 3: China Oriental—Ownership structure	10
Figure 4: China Oriental—Capacity	10
Figure 5: Scrap Price Trend	13
Figure 6: China: Pig iron price vs HRC price	13

Unless mentioned otherwise, share prices and valuations are as of May 21, 2004

Valuations and Rating

Major valuation issues: Stand-alone valuation is preferred

The reason for our preference is simple. COG is a newly-created company in its growth stage. To compare its valuations with other listed peers would introduce undue distortions in deriving price targets, in our view. Hence our preferred valuation method involves PBR versus ROE with a DCF check. Based on our stand-alone PBR versus ROE valuation supported by our DCF analysis, we initiate on COG with an Overweight rating based on the view that risks associated with the company should be largely priced in at current share price levels. Given the current market sentiment we do not expect any near-term positive catalysts to uplift the stock to our implied fair value range of HK\$1.75-1.78. But over a 12-month period, we believe the risk is biased towards the upside for this stock, in our view.

PBR versus ROE

Average ROE for COG between 2000 and 2003 stood at 83%. This is understandable given COG is a newly-created company which is in its startup-growth phase. We expect ROE to contract down to more realistic levels over the next five years as the company grows and matures.

We expect COG's average ROE for the five-year period between 2004 and 2008 to contract to 33% Table 1. As a high beta stock, COG's cost of equity using a risk-free rate of 4% and equity risk premium of 10% is 27%. Considering our long-term growth rate of 4%, the implied fair value target PBR comes to 1.3x. Applying this multiple against our average projected five-year BPS of Rmb 1.40, we derive our implied fair value price of HK\$1.75, representing a 36% upside potential from the current share price level.

Table 1: China Oriental—PBR versus ROE valuation

%/Rmb per share	2000-2003	2004E-2008E
Average ROE	83%	34%
Growth	4%	4%
Ke	27%	27%
Target P/B multiple	3.5	1.3
BPS	Rmb0.22	Rmb1.42
Implied fair value	Rmb0.75	Rmb1.86
Implied fair value (HK\$)	HK\$0.70	HK\$1.75

Source: Company reports and JPMorgan estimates.

DCF support

COG is a high-beta stock and therefore has a very high cost of equity. Although we believe eventually the beta should come down as the company demonstrates to the market that it is capable of sustaining its cash flow and returns, we believe that prior to demonstrated proof, COG is likely to remain a high-beta stock. We, therefore, took its current beta as a stress test measure. We derived our WACC of 23% by using a target debt-equity split of 10-90% with an average cost of debt of 5%. The cost of equity used was 27% as in the case of our PBR versus ROE valuation, with a terminal growth rate of 4%. The long-term billet price was assumed to be \$250/ton, versus the current \$453/ton prevailing in the China market.

Based on the above set of assumptions, we arrived at our implied fair value estimate of HK\$1.78, representing a 38% upside potential from current share price levels.

Investment thesis

Since being listed in Hong Kong on March 1 at an IPO price of HK\$2.75, China Oriental has witnessed a 62% correction from its high price of HK\$3.40, especially in light of recent negative market sentiment associated with monetary tightening and US interest rate hike outlooks. On the positive side, we believe the market has largely priced in macro risks. Furthermore, COG's earnings momentum is likely to be supported during the coming industry down cycle through its volume expansion and positive product mix shift. The company is being guided by a team of experienced managers who are seeking expansion in key product segments within the long products market that they understand best.

On the risk side, we must point out that our positive earnings scenario is based on a basic premise that COG will be able to complete its current expansion plans. Considerable risks to our earnings and valuation scenario exists if, for any reason, the expansion projects are either delayed or abandoned. On another level, although we feel that the market has already largely priced in macro risks, we should also note that the longer it takes for the government to slow down investment and industrial production growth, the bigger the risk of hard landing and a more negative scenario to our base case steel price assumptions.

Investment Positives

Operating leverage

As elaborated in greater detail in the earnings outlook section of this report, COG is likely to increase production and volume sales by 8% Y/Y in 2004 and 7% Y/Y in 2005 as a result of downstream capacity additions. Since these are relatively less capital intensive downstream capacity additions, we believe the operating leverage impact will be felt on the bottom line.

Positive product mix shift

As also elaborated in greater detail in the earnings outlook section and investment risk section of this report, the addition of the 1 million ton H-beam rolling capacity should allow the company to derive higher prices for each ton of steel sold. In 2005, we expect H-beam sales to comprise 12% of COG's sales by volume while commanding 16% of revenues. This is likely to result in overall ASP rise to Rmb3,087/ton in 2005E, from Rmb3,023/ton in 2004E.

Management focus on products it knows best

Mr Han Jingyuan, chairman and CEO, has over 20 years' experience in the iron and steel industry. Other senior members of the management also have extensive industry and management experience, including Ms Chen Ningning, vice-chairman. Ms Chen has, since 1995, worked for PMC, a key raw materials supplier to Chinese steel companies and is very knowledgeable about the dynamics of the steel industry. Mr Zhu Jun, executive director, who is in charge of daily operations of Jinxi, has over 10 years experience in the iron industry.

The combined years of experience in the iron and steel industry as well as experience in iron ore mining and trading have endowed the management with a deep understanding of the steel industry dynamics in northern China, in our view. It is seeking to expand downstream in long products, a market which they understand well. We believe this strategic move is preferable to blindly expanding into flat

product segments at the peak of the cycle with little understanding of market dynamics involved in those segments.

Investment Risks

Macro risk—hard or soft landing?

This is a risk that we believe is already acknowledged in the market. Nevertheless, we remain concerned about the potential for hard landing, should the Chinese government be unable to rein in investment growth and industrial production growth rates in a relatively quick period.

Based on 1Q CY04 industrial production and fixed asset investment growth relative to our projected economic growth, we believe there is an increased likelihood of a hard landing the longer it takes for the government to decelerate the pace of IP and FAI growths (Table 2). The relevance for our steel cycle forecast is that the weaker the projected IP and FAI growth rates, the weaker the steel demand growth rate and increased likelihood that steel prices will go through a stronger correction than what our current forecasts suggest.

Table 2: China—Elasticity of IP & FAI growth to GDP growth

	90-95	96-00	01-03	04E-05E	1Q04
%					
GDP growth	11%	8%	8%	9%	9*
IP	15%	10%	13%	15%	18%
FAI	26%	6%	19%	21%	46%
Elasticity ratios					
IP	1.4	1.2	1.6	1.6	1.9
FAI	2.5	0.8	2.3	2.4	5.1

* Average forecast annual GDP growth rates for 2004-2005E

Source: CEIC, JPMorgan estimates.

Project completion risk

COG's current investment plans call for installing a 1.0 million ton H-beam rolling capacity by 2H 2005. If, for any reason the project gets delayed or is abandoned, we believe there is considerable downside risk to our earnings forecast and valuation work. Our analysis suggests that if the project is either delayed or put off, then our 2005E revenue forecast would fall by 16% from the base case, with a 30% negative impact from the base case on operating profit and EPS (Table 3). Overall ASP would fall by 4% from the base case, and OP margin would fall to 17% from the 21% base case, suggesting that COG would display expected revenues and margin trend in a down cycle environment.

Table 3: Sensitivity of COG's earnings to H-beam production and sales, 2005E

	2004E	Base Case 2005E	No H-Beams 2005E	% Change from Base Case
Rmb in Millions				
Turnover	7,929	8,674	7,311	-16%
OP	1,618	1,782	1,245	-30%
NP	1,486	1,408	980	-30%
Wtd EPS	0.56	0.48	0.34	-30%
ASP	3,023	3,087	2,972	-4%
OP margin	20%	21%	17%	
Net margin	19%	16%	13%	

Source: JPMorgan estimates.

The Chinese government is currently trying to cool the economy by circumventing the creation of excess capacity, especially in the steel industry. In short, the key highlights from National Development and Commission's November 19, 2003 circular stipulate that:

- In principle, there will be no approval for new independent steel mills
- Minimum project requirements should meet:
 - 1). Blast furnace capacity of over 0.9 million tons, converter over 100 tons,
 - 2). Pulverized coal injection
 - 3). Coal consumption pre ton should be lower than 0.7 ton, water consumption below 6 ton.
 - 4). Basic infrastructure for iron ore, coke, and water transport in place.
- The government will inspect existing expansions to check if they meet criterion relating to land and environmental protection. Any violation would result in the suspension of construction, bank loan and fines.

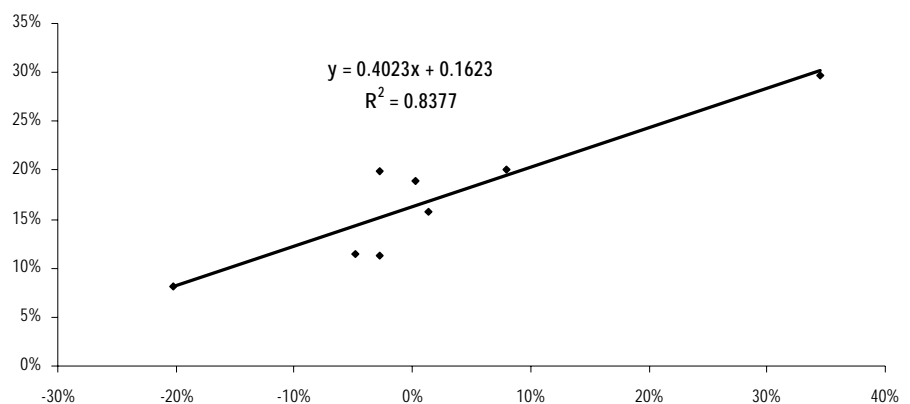
Industry fundamentals

Secular versus cyclical issues

Long-term growth for infrastructure building in a \$1,000 per capita GDP such as China should come as an intuitive given. Secular trendline growths in both steel consumption and fixed asset investment are likely to remain in positive territory if we were to take a 10-15 year (secular) view.

In the process of getting there, however, we are likely to see a few price cycles due to shorter term imbalances in supply and demand. This is the cyclical issue that we have been concerned about since 2H CY03. Historically, fluctuations in fixed asset investment growth have had a significant influence on billet price movements in China (Figure 1).

Figure 1: China—Annual fixed asset investment growth vs. average annual billet price changes, 1996-2003



Source: Metal Bulletin, CEIC.

Using fixed asset investment as the demand variable and overall steel supply growth (production + net imports) as our supply variable, our analysis suggests that the impact of long product demand driver in the form of fixed asset investment growth will be 10 times the impact that overall growth in steel supply has on billet prices (Table 4). This suggests that if FAI growth in China decelerates by 1%, overall steel supply growth (production + net imports) should decelerate by 10% in order to maintain price stability.

Table 4: China—Billet price sensitivity to fixed asset investment growth & total steel supply growth, 2004E

% , US\$/Ton

	Billet price	FAI growth	Supply growth	% Chg from base case
Base case	\$355	27%	25%	
-1% FAI growth	\$352	26%	25%	-1.1%
-1% Supply growth	\$356	27%	24%	0.1%

Source: JPMorgan estimates.

This concept lies at the heart of our cyclical concern. In the face of a significant slowdown expected in fixed asset investment, steel supply must decline much faster in order to maintain price stability. As it stands, we are most likely looking at merely a decelerated pace of steel supply growth in China over the next six to eight quarters based on our current forecasts, so the directional movement of steel prices over this period is likely to be one of downward trend.

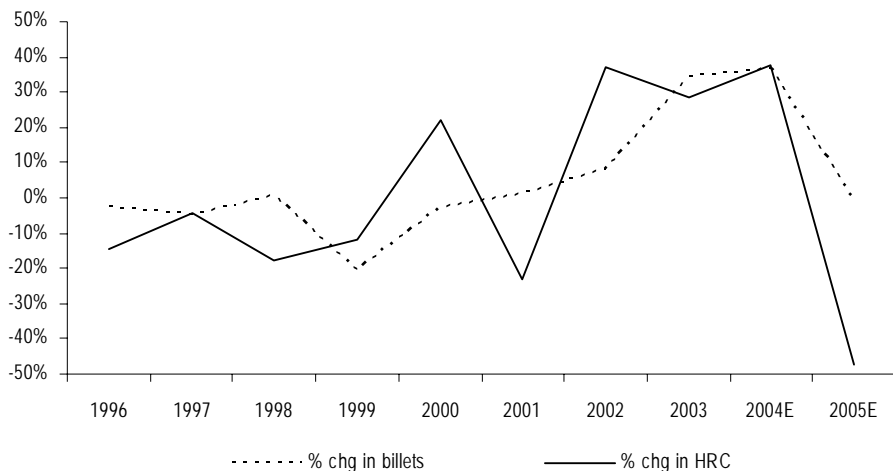
Long product pricing dynamics

Billet price: Tends to be less volatile than hot rolled coil prices

Billet price has shown less volatile swings than hot rolled coil price based on our historical observations (Figure 2). In our view, the downswing expected for billet prices from China's expected macro slowdown should be less severe than for flat product prices in 2H04 and FY05. This suggests that developing long product producers such as China Oriental who are expanding their volumes and changing their product mix should be able to attain positive earnings momentum even in the face of a cyclical downturn in this particular cycle.

Figure 2: China—annual average billet price changes versus HRC price changes

%



Source: Metal Bulletin, JPMorgan estimates.

Downstream product prices are priced at a spread over upstream products

Narrow and mid-width strips are essentially flattened versions of billets. H-sections are also processed downstream products from billets. As such they generally tend to be priced at a spread over billet prices, with room for fluctuations depending on individual product supply and demand conditions. Generally speaking, however, as downstream supply and demand impact upstream activities, the directional movements of long product prices tend to be in the same direction. (Table 5)

Table 5: China—Long product price outlook

\$/ton	2000	2001	2002	2003	2004E	2005E
Billets	\$194	\$190	\$196	\$255	\$355	\$352
Strips-narrow	\$265	\$219	\$218	\$279	\$374	\$370
Strips-medium					\$380	\$377
H section					\$540	\$478

Source: Metal Bulletin, Company Data, JPMorgan estimates.

H-beams: A classic case of steel commoditization?

H-beams enhance efficiency of construction projects and reduce costs for construction companies. Currently, there is a supply shortage in China for this product, but we believe over the medium term, H-beams may very likely display classic patterns of steel commoditization. In essence, scarce products with low entry barriers would begin to command high prices, but new entrants will quickly build capacity and run the risk of glutting the market. A supply glut will inevitably result in price correction under such circumstances.

The positive benefit for a growing early entrant such as China Oriental in this particular product line would enable it to enjoy the benefits as an early entrant. More importantly, a quickly shifting product mix towards the higher priced items could perhaps bias the overall ASP towards the upside during the company's growth phase, even if H-beam prices were going down, in our view.

China's H-Beam consumption in early growth phase

H-sections are high margin downstream steel products. However, the entry barrier to this product line tends to be low since H-sections have been in use throughout the world for a number of years, forming the backbone of modern architecture. While offering about 2x the lateral rigidity and bending resistance compared with I-Beams, H-Beams tend to be about 20% less in weight. Hence, construction companies can often reduce costs by up to 30% by using H-beams, stemming from increased efficiency in building speed. As Chinese construction companies have been transitioning to H-beam usage, demand for this product has been picking up markedly, with very few players currently in the market. In fact, in 2003 China turned into a net importer of H-beams (Table 6).

Table 6: China—Historical H-beam supply & demand

Million tons	2000	2001	2002	2003
Shipments	0.4	0.5	1.0	2.0
Domestic production	0.5	0.7	1.2	1.6
Net Import(export)	(0.2)	(0.2)	(0.2)	0.4
Total supply	0.3	0.5	1.0	2.0
%change		52%	100%	101%

Source: Maanshan Iron & Steel, Chinese Customs Statistics.

H-Beams: Low entry barrier due to relatively simple technology

H-beams are relatively high-end construction grade steel, but the technology involved in making basic H-beams is not complex, as in say, high strength automotive sheets or seamless pipes. There are a number of steel manufacturers both in and outside China with published plans for additional H-beam capacity over the next several years. In fact, our collected sample looks to quadruple H-beam capacity by the end of 2005 (Table 7). We believe the plans may very well be exaggerated, since the government's current initiative to check overinvestment in steel capacity calls for approving no new independent steel mills and a government inspection of existing capacity for meeting minimal environmental protection standards.

Table 7: China—Published plans for H-beam capacity additions

1,000 tons

	2003	2004E	2005E	2010E
Maanshan Iron & Steel—H beam Large	600	600	800	800
Maanshan Iron & Steel—H beam Medium	200	200	500	500
Laiwu Iron & Steel—H beam Large		700	700	700
Laiwu Iron & Steel—H beam Medium	600	600	600	600
China Oriental			1,000	1,000
Panzhuhua Iron&Steel		200	200	200
Angang	100	100	100	100
Baotou Iron&Steel			200	200
Rizhao Jinghua Steel			500	500
Shanxi ChangZhi Iron&Steel			500	500
INI Steel			1,000	1,000
Handan Iron&Steel				1,060
Total	1,500	2,400	6,100	7,160

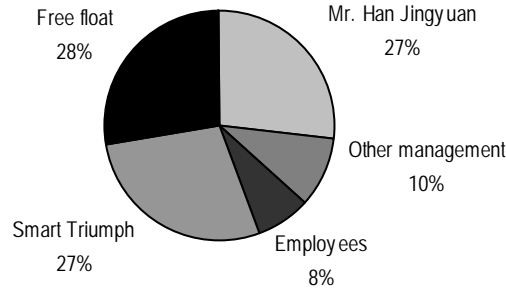
Source: Company reports.

Company description

COG is a privately-owned holding company incorporated in Bermuda. Its only operating asset is the 97.6% owned Jinxi Iron & Steel Limited (Jinxi), a medium-sized steel producer with a capacity of 3.1 million tons, located in the Qianxi county, Hebei province. COG's location is within the traditional Jing-Jin-Tang area (which includes Beijing, Tianjin and Tangshan), and is about a two-and-a-half hours' drive to Beijing or Tianjin. Therefore it is very close to the two traditional demand centers for construction related steel products.

After a corporate reorganization in 2003, the management and employees now own 45% with Mr Han Jingyuan, chairman and CEO, owning 27%. As a foreign-invested company via Smart Triumph which holds a 27% equity stake, COG enjoys associated tax benefits: only 3% local tax in 2003-2004, while state corporate tax is exempted—18% for three years from 2005-2007, which will return to a normal 33% thereafter.

Figure 3: China Oriental—Ownership structure

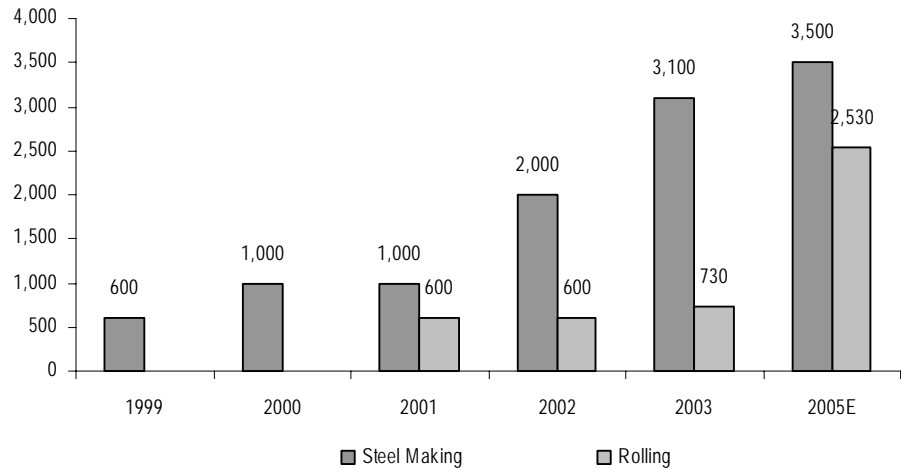


Source: Company reports.

COG currently produces two construction-related long products: billets and hot rolled (HR) narrow strips, accounting for 69% and 31%, respectively, of the turnover for FY03. COG’s downstream buyers are re-rollers and pipe manufacturers, who further process them into angles, rebars, wire rods and pipes.

Figure 4: China Oriental—Capacity

'000 tons



Source: Company reports & company estimates.

The company has gone through a period of rapid volume growth—its steel-making capacity increased at 51% CAGR from 0.6 million tons in 1999 to 3.1 million tons by end of 2003. In 2001, it added a further hot rolling capacity of 0.6 million tons, producing narrow HR strips with a width ranging from 145 to 355mm. Its sales volume of billets and strips combined has been growing at a 63% CAGR from 0.53 million tons in 2000 to 2.4 million tons in 2003. COG is further committed to increasing its capacity and moving down to higher value-added areas such as an 0.8 million ton mid-width HR strip rolling mill in 2004, and 1.0 million tons of H beams in 2005 (Table 8)

Table 8: China Oriental—Details of planned investments

	Year of Completion	Capex(Rmb MM)
Upgrade 1 x 120 m3 blast furnace to 450 m3	2005	100
Upgrade 2 x 20m2 converter furnaces to 1 x 60 m2	2005	120
New mid-width strip rolling	2Q04	200
H beam rolling	2005	800
Upgrade coal powder blowing technique	2004	30
Upgrade recycle energy for power generation	1H04	50

Source: Company.

The rapid capacity expansion has been achieved at a relatively low cost due to several factors: smaller-sized domestic blast furnace designs as well as outsourcing of raw material treatment such as coking and sintering in favor of investing in the physical assets themselves. For instance, the largest blast furnace currently employed by the company is a 450m³, versus 5,000m³+ blast furnaces operated by large-scale integrated producers in the world today. Hence, while it can take three to five years and US\$1 billion+ in investments to build a large-sized blast furnace, COG has opted to develop its capacity by increments in a fashion typical of smaller scale Chinese mills. In the course of the next two calendar years, the company currently plans to invest Rmb1.5 billion to upgrade its existing facilities, as well as to expand downstream into mid-width HR strips and H-beams.

Earnings outlook

Operating leverage

Based on the management's current capacity expansion plans, we estimate that sales volume will likely grow by 8% in 2004 and 5% in 2005 (Table 9). The operating leverage from increased volumes plus a favorable pricing environment will likely result in net profit growing by 37% Y/Y in 2004, but undergo a 9% erosion in 2005, mostly from a higher tax rate taking effect in 2005. We believe this is significant, since our expected rise in ASP from product mix change and the increased volume in 2005 will likely support COG's earnings even in the face of a cyclical downturn.

Due to the impact of new shares issued during the IPO, weighted EPS is likely to grow by 8% in 2004 while eroding by 17% in 2005. In our view, the degree of earnings erosion in 2005 we expect from COG is mild when considering a cyclical downturn.

Product mix change

When COG begins selling H-beams in 2H05, we estimate that it will represent 13% of the total volume sales while representing 16% of total revenues in 2005 (Table 9). The point is that despite our outlook for declining steel prices through 2005, overall ASP will likely show improvements based on this product mix shift towards higher priced items.

Table 9: China Oriental—Sales forecast

'000 tons/Rmb/ton

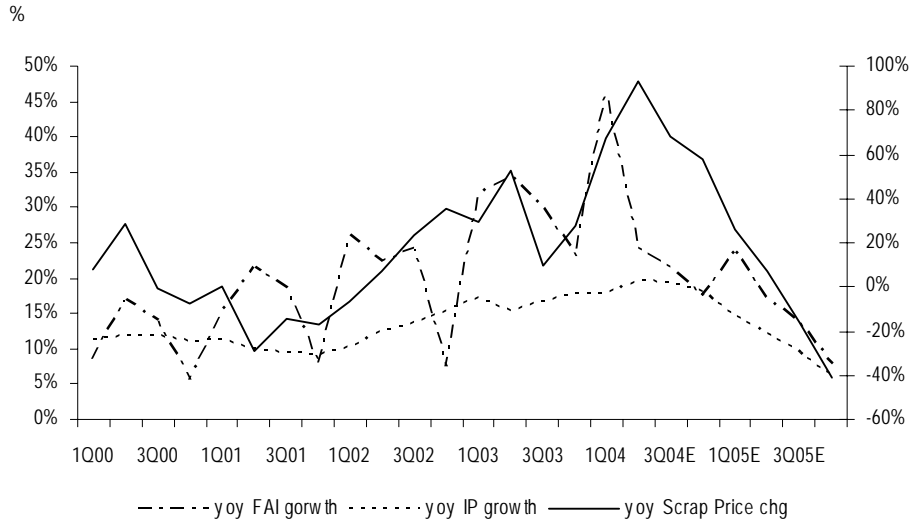
	2000	2001	2002	2003	2004E	2005E
Billets	498	547	954	1,714	1,523	960
Strips-narrow	32	346	566	707	750	750
Strips-medium					350	700
H Section					0	350
Total sales volume	523	882	1,521	2,421	2,623	2,760
Product mix (volume)						
Billets	95%	62%	63%	71%	58%	35%
Strips-narrow	6%	39%	37%	29%	29%	27%
Strips-medium	0%	0%	0%	0%	13%	25%
H Section	0%	0%	0%	0%	0%	13%
Product mix (value)						
Billets	92%	58%	60%	68%	56%	32%
Strips-narrow	8%	42%	40%	31%	29%	26%
Strips-medium	0%	0%	0%	0%	14%	25%
H Section	0%	0%	0%	0%	0%	16%
Other	0%	0%	1%	1%	1%	1%
ASP (Rmb)						
Billets	1,609	1,576	1,625	2,109	2,936	2,849
Strips-narrow	2,194	1,814	1,807	2,314	3,090	3,000
Strips-Medium					3,142	3,051
H Section						3,874
Total ASP	1,666	1,691	1,701	2,180	3,023	3,087

Source: Company reports and JPMorgan estimates.

Stabilizing input costs

We believe on an annual basis, scrap price and pig iron prices are likely to show a Y/Y decline beginning in 2H 2004 and through FY2005. Scrap prices have tended to show a good degree of sensitivity to industrial production and fixed asset investment growth rates in China. Despite the fact that Chinese mini-mills tend to produce long products, we believe most Chinese blast furnace operators have been stretching their capacity to their limits with maximum scrap and pig iron inputs, thus driving up scrap and pig iron consumption in China. However, as industrial production growth and fixed asset investment growth slow down, we expect scrap prices to show a declining trend over 2H04 and FY05.

Figure 5: Scrap price trend

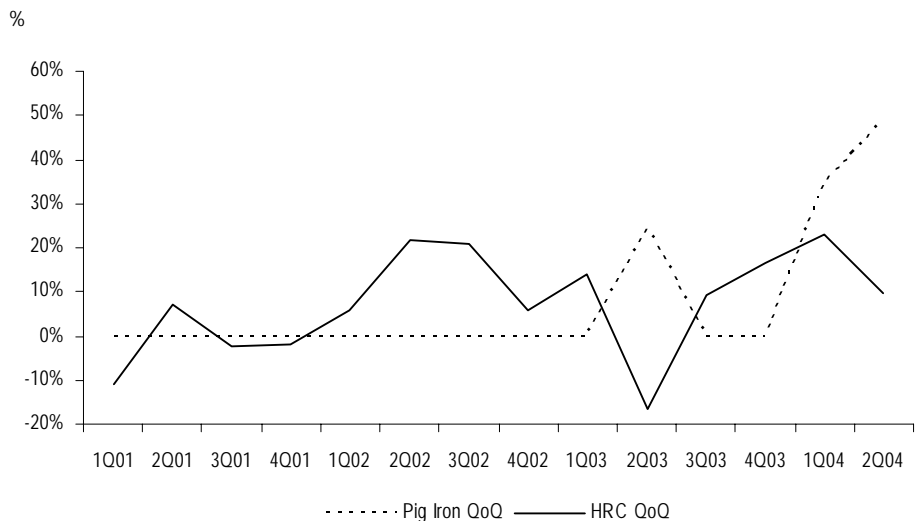


Source: CEIC, Datastream, JPMorgan estimates.

COG's scrap rate stands at 16% based on our discussion with the management, so declining scrap price will likely alleviate a lot of cost pressures on COG's margins. Similarly, we estimate that the company currently has nearly 0.4 million tons in external pig iron sourcing needs based on its production data. This amounts to 16-17% of the finished product output. World-class integrated mills typically attempt to minimize the gap between upstream and downstream capacity so as to minimize the need for externally sourced pig iron and scrap. For example, JFE Holdings in Japan has a near-perfect capacity alignment which allows it to be a seller of internally generated scrap, and has no need for externally sourced pig iron.

The price of pig iron in the Chinese market has shown significant volatility since 2H03 (Figure 6). However, as steel prices begin to show signs of deterioration, we expect pig iron prices to return to historical levels by late 2005.

Figure 6: China—Pig iron price versus HRC price



Source: Datastream, Metal Bulletin.

This brings us to the topic of coke and iron ore price exposure for COG. COG purchases its iron ore and coke in the spot market. The Hebei province in which COG is located is the largest iron ore producing region in China and accounts for nearly 27% of national output. COG's top five iron ore suppliers are located within 30 kilometers of its production site. COG currently sources about 70% of its ore requirement domestically but it should be noted that domestic iron ore tends to have low iron content relative to imports from Australia and Brazil. Since purchases are conducted in the spot market, we expect volatility in iron ore and coke costs for the company. As COG does not own its own coking facilities, it procures its coke needs from the nearby Shanxi province. On an average basis, we have assumed that iron ore and coke prices are likely to show a Y/Y increase trend through 2005, in line with JPMorgan global metal group's current outlook.

Table 10: China Oriental—Raw material cost breakdown

Rmb in millions

	2000	2001	2002	2003	2004E	2005E
Iron ore	242	526	626	1,701	2,297	2,702
Coke	87	191	363	1,176	1,524	1,730
Other	62	98	421	825	1,500	1,382
Auxillary materials	93	137	161	265	398	436
Rmb/Ton						
Iron ore and third party sinter	456	588	412	702	876	962
Coke	165	214	239	486	581	615
Other	118	109	277	341	572	492
Auxillary materials	175	154	106	109	152	155

Source: JPMorgan estimates, Company data.

In any event, we believe stabilizing cost outlook for scrap and pig iron costs alone would contribute significantly to elevating COG's operating margin in 2005 by 1% relative to 2004. We thus expect a combination of operating leverage, ASP improvement through product mix shift and stabilizing input costs to contribute to overall operating margin improvement, despite expecting a down-cycle year in 2005 for the Chinese steel industry.

Table 11: China Oriental—Consolidated income statement

Rmb in millions, year-end December

	2000	2001	2002	2003	2004E	2005E
Turnover	871	1,490	2,571	5,278	7,929	8,674
COGS	651	1,180	1,893	4,046	6,212	6,788
Gross profit	220	310	678	1,232	1,716	1,886
Other revenues	-13	-19	-21	-24	-36	-39
Selling & admin expenses	47	63	78	78	118	121
Other operating expenses	5	21	18	10	16	21
Operating profit	181	245	604	1,167	1,618	1,782
Net interest expense	14	16	18	31	40	15
Share profit of an associated company			1	7	0	0
Pre-tax profit	167	229	586	1,143	1,578	1,767
Income tax	52	71	189	40	55	318
Net profit before minority interests	116	158	397	1,103	1,523	1,449
Minority interests	3	4	9	26	36	41
Consolidated net profit	113	154	388	1,076	1,486	1,408
Wtd EPS	0.05	0.07	0.18	0.51	0.56	0.48
Effective tax rate	31%	31%	32%	4%	4%	18%
Gross margin	25%	21%	26%	23%	22%	22%
Operating margin	21%	16%	23%	22%	20%	21%
Pre-tax margin	19%	15%	23%	22%	20%	20%
Net margin	13%	10%	15%	20%	19%	16%
EBITDA margin	28%	22%	26%	24%	22%	23%
EBITDA	246	322	675	1,263	1,766	1,966
ROE	41%	62%	115%	114%	68%	42%
Net margin	13%	10%	15%	20%	19%	16%
Asset turnover	111%	139%	116%	136%	141%	134%
Leverage	288%	432%	655%	410%	258%	194%

Source: Company reports and JPMorgan estimates.

Table 12: China Oriental—Consolidated balance sheet

Rmb in millions, year-end December

	2000	2001	2002	2003	2004E	2005E
Current assets	374	533	1,322	1,831	2,924	3,410
Cash and bank balances	20	64	118	153	381	629
Trade receivables	129	154	625	267	400	438
Inventory	108	158	242	691	1,061	1,160
Others	117	158	338	720	1,082	1,183
Total intangible assets and non-current assets	413	543	892	2,046	2,683	3,059
Interests in an associated company			1	6		
Net fixed assets	375	392	771	1,500	2,052	2,469
Construction in progress	16	124	112	490	630	590
Deferred costs	19	21	4	0	0	0
Others	3	6	4	50	0	0
Total assets	787	1,076	2,215	3,877	5,607	6,470
Current liabilities	385	535	1,690	1,906	2,551	2,596
ST debt	96	7	190	322	262	112
Accounts payable	81	166	165	293	450	492
Advance from customers	153	196	703	1,088	1,634	1,787
Other payable		1	2	3	3	3
Taxation payable	51	73	189	193	195	195
Amount due to related parties	4	92	441	7	7	7
Long term liabilities	121	286	178	1,002	862	512
Long-term debt	121	284	162	683	543	193
Amount due to related parties	0	-	0	261	261	261
Others		2	16	58	58	58
Total liabilities	507	821	1,868	2,908	3,413	3,108
Minority interests	7	6	8	23	23	23
Share capital	159	159	224	224	224	224
Share premium						
Retained earnings	115	90	114	722	1,947	3,115
Shareholders' funds	274	249	338	946	2,171	3,338
Total Liabilities and shareholders' equity	787	1,076	2,215	3,877	5,607	6,470
Check	0.0	0.0	0.0	0.0	0.0	0.0
Net debt	197	226	234	852	424	-324
Net Debt/Equity	72%	91%	69%	90%	20%	-10%
Total Debt/Equity	185%	330%	552%	307%	157%	93%

Source: Company reports and JPMorgan estimates.

Table 13: China Oriental—Consolidated cash flow statement

Rmb in millions, year-end December

	2001	2002	2003	2004E	2005E
Cash flow from operations	142	96	290	1,473	1,550
Net profit	154	388	1,076	1,486	1,408
D&A	77	71	97	148	184
Changes in net working capital	-144	-303	421	-160	-42
Other	55	-60	-1,304		
Cash flow from investments	-102	-175	-429	-700	-600
Capex	-102	-181	-429	-700	-600
Disposal of equipment		7	1		
Others		-1			
Cash flow from financing	73	133	173	-545	-702
Debt raised (repaid)	163	425	522	-200	-500
Dividend paid	0	0	-480	-297	-282
Equity raising	0	71	0		
Other	-90	-363	131	-48	80
Change in cash	113	54	34	228	248
BOP cash		64	118	153	381
EOP cash	64	118	153	381	629

Source: Company reports and JPMorgan estimates.

Henry Kwon
(82-2) 758-5732
henry.c.kwon@jpmorgan.com

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