China Oriental

Upgrading to Neutral on improving outlook of steel prices

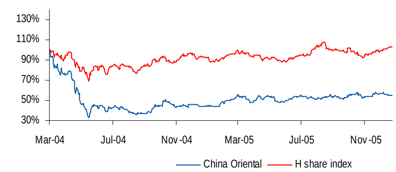
Upgrade
Neutral
Previous Rating: Underweight

HK$1.70
10 April 2006
Price Target: HK$2.00

Hong Kong
Steel

Feng Zhang
(852) 2800 8513
feng.zhang@jpmorgan.com

China Oriental: Share price performance chart



Source: Datastream.

- **Upgrade to Neutral; revising earnings estimates:** We upgrade our rating on China Oriental to Neutral from Underweight and cut our FY06E EPS by 39%. However, we expect FY07E EPS to grow by 59% on recovering steel prices.

- **Revising target price:** We raise our 12-month target price toHK$2 from HK$1.46 by applying 1x P/B to FY07E P/B (previously we used 0.8x one-year forward P/B), as we expect China Oriental's ROE to rise from 12% in 2006 to 16% in 2007.

- **We expect margin expansion in 2007:** We expect China's spot steel prices to increase at end-2006 on the back of slowing crude capacity growth. China Oriental's management plans to expand production by about 10% in FY06 and 5% in FY07. We believe the new H beam project (to be completed in mid-2006) should improve the company's product mix and help expand margins; and the CRC production from the new JV should also help contribute to the bottom line going forward. As a result, we expect margin expansion for China Oriental in 2007.

Reuters: 0581.HK; Bloomberg: 581

Rmb in millions, year-end December

	2002	2003	2004E	2005	2006E	2007E
Sales	2,571	5,278	9,119	9,183	9,877	10,905
NP	388	1,076	1,173	847	590	938
EPS (Rmb)	0.18	0.51	0.42	0.29	0.20	0.32
EPS (Y/Y)	152%	177%	-17%	-31%	-30%	59%
BPS (Rmb)	0.16	0.45	1.40	1.58	1.74	2.00
DPS (Rmb)	0.18	0.23	0.08	0.05	0.04	0.06
EPS growth	152%	177%	-17%	-31%	-30%	59%
P/E	9.6	3.5	4.2	5.9	8.4	5.1
P/B	11.0	3.9	1.3	1.1	1.0	0.8
EV/EBITDA	6.7	4.0	5.1	4.9	6.1	4.1
Dividend Yield	10%	13%	5%	3%	2%	4%
ROE	115%	114%	30%	18%	12%	16%
Performance				1mth	3mths	12 mths
Absolute (%)				-1.0	-9	-7
Relative (%)				-14.0	-28.0	-52

52-week range	197-160
Mkt cap (HK$ MM)	4,939
Mkt cap (US$ MM)	634
Free float (%)	28
AVG dailiy volume (MM)	6
H share index	6,898
HK$/US$	7.79

Source: Company, Datastream, JPMorgan estimates.

J.P. Morgan Securities (Asia Pacific) Limited

Rating upgraded on improving outlook of steel prices

We are upgrading China Oriental's rating to Neutral from Underweight. Although we have cut our FY06E EPS by about 39% as we expect overhang capacity to depress prices in the next six months, we expect steel prices to increase in 2007 on the back of slowing crude capacity growth in China.

Table 1: China Oriental—What has changed?

	Old	New	Change
ASP (Rmb/t)	2,804	2,695	-4%
COGS (Rmb/t)	2,412	2,455	2%
EPS (Rmb/share)	0.33	0.20	-39%

Source: Company data, JPMorgan estimates.

Table 2: China Oriental—Major assumptions

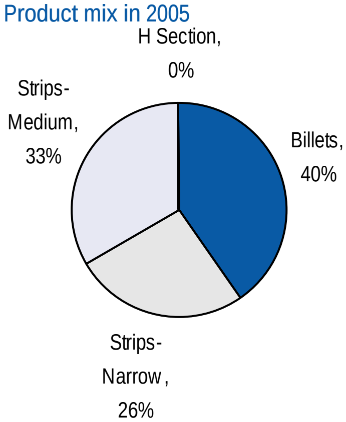
	2003	2004	2,005	2006E	2007E
ASP(Rmb/t)	2,180	2,694	2,753	2,695	2,821
		24%	2%	-2%	5%
Volume sales('000 tons)	2,421	3,385	3,336	3,665	3,865
		40%	-1%	10%	5%
COGS(Rmb/t)	1,671	2,307	2,386	2,455	2,441
		38%	3%	3%	-1%
Margin(Rmb/t)	509	387	367	240	380
		-24%	-5%	-35%	59%

Source: Company data, JPMorgan estimates.

Product mix

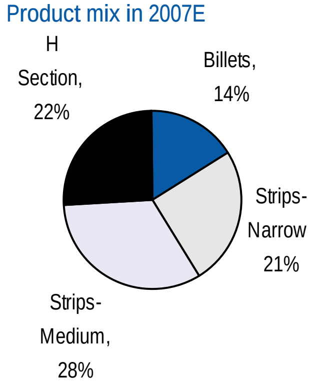
In 2005, strips and billets accounted for about 60% and 40% of China Oriental's total volume sales, respectively. As the company's H beam production comes on stream in mid-2006, while strips will likely account for about 49% of volume sales, H beam and billets will likely account for about 22% and about 14% in 2007. H beams are value-added finished steel products that will help the company expand margins. Note that the breakdown of product mix in the charts below excludes JV production, which is currently being tested.

Figure 1: Product mix in 2005



Source: Company.

Figure 2: Product mix in 2007E



Source: JPMorgan estimates.

Feng Zhang
(852) 2800 8513
feng.zhang@jpmorgan.com

Balance sheet check

We expect China Oriental to turn free cash flow positive in 2007 as capex will likely fall from the FY05 peak and operating cash flow will grow on the back of stronger steel prices. We expect the company to carry little or no debt on the balance sheet in the next two years.

Table 3: China Oriental—Cash flow and balance sheet

Rmb in millions

	2003	2004	2005	2006E	2007E
Operating cash flow	290	393	620	578	1,264
Capex	-429	-401	-850	-600	-500
Free cash flow	-138	-57	-230	-22	764
Net debt/equity	90%	-27%	-2%	1%	-10%

Source: Company data, JPMorgan estimates.

Risks to target price

If steel prices fail to increase in 2007 as expected, due to unexpected economic slowing down or faster-than-expected supply growth, then we might see earnings under continued pressure and the stock might not hit our target price.

If, on the other hand, there are much stronger steel price moves on the back of strong economic growth or/and slower-than-expected supply growth, then the risk to our target price is probably on the upside.

Spot prices might pause for a breather in the short term

Spot HRC and CRC steel prices in China have rallied by about 30% since the recent troughs in December 2005. We expect China's spot steel prices to consolidate at about +/-10% around the current levels in the next 3-6 months before picking up again towards the end of the year.

The export market remains very strong. However, the Chinese government might cut the export VAT rebate of finished steel products from 11% to 8% and impose export tariff on steel semis. This will likely increase export costs and result in a correction of domestic steel prices.

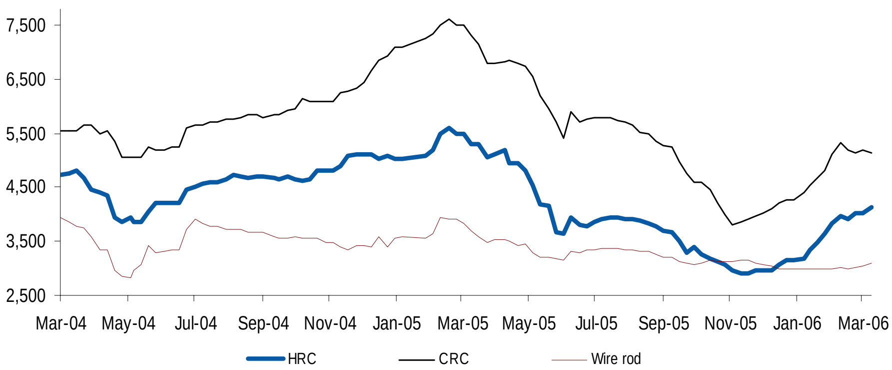
However, we believe the correction should be mild; we expect the magnitude of the VAT rebate cut and export tariff increase to be about 3-5%. The 3-5% cost increase would certainly discourage export, but would not likely eliminate it.

We see signs of changing supply and demand dynamics that we believe would lead to a better pricing environment in China in 2H06 and 2007.

Feng Zhang
(852) 2800 8513
feng.zhang@jpmorgan.com

Figure 3: China—Spot steel prices

Rmb/t incl VAT



Source: Mysteel.

China's crude capacity growth to slow down

While global steel companies cut production, China's rapid capacity expansion is a major concern in the industry. We expect the country's crude capacity growth to slow down from the current 21% Y/Y to 9% Y/Y in 2006 and 6% Y/Y in 2007, as the central government is curbing capacity expansion and enforcing the closure of outdated capacity.

Table 4: Global and China crude steel production

'000 tons

	1999	2000	2001	2002	2003	2004	2005
World	788,995	847,596	850,217	903,750	968,256	1,066,487	1,129,365
China	123,954	127,236	150,866	182,249	220,115	280,486	349,362
World ex-China	665,041	720,360	699,351	721,501	748,141	786,001	780,003
Change		8%	-3%	3%	4%	5%	-1%

Source: IISI.

We believe the Chinese government will introduce measures to force the shutdown of small steel mills, which consume much more energy and cause more environmental problems than large steel mills. Although this is unlikely to reduce overall steel capacity, it would likely restrict capacity growth in the next two years.

The National Development and Reform Commission (NDRC) recently announced its aim to shut down all blast furnaces with volumes below 200 cubic meters by end-2006, which represents about 43 million tons of pig iron capacity—about 10% of current pig iron capacity.

Table 5: China—Steel capacity

MM tons

	2000	2001	2002	2003	2004	2005	2006E	2007E
Pig iron	164	173	198	247	318	390	427	455
Change		5%	14%	25%	29%	23%	9%	7%
Crude	172	197	230	286	356	432	469	495
Change		15%	17%	24%	24%	21%	9%	6%
Finished	184	215	248	293	341	391	443	493
Change		17%	15%	18%	16%	15%	13%	11%
Plate	17	19	22.1	23.1	27.1	35	44	51.5
Change		12%	16%	5%	17%	29%	26%	17%
HRC	29	34	36	46	51	64	88	114
Change		17%	6%	28%	11%	25%	38%	30%
Strip	12	18	24	26.4	32.4	38	39	40
Change		50%	33%	10%	23%	17%	3%	3%
Wide strip	-	1	2	5	8.6	15	20	24
Change			100%	150%	72%	74%	33%	20%
Rod	55	64	76	92	106	112	116	120
Change		16%	19%	21%	15%	6%	4%	3%
Wire rod	32	37	42	50	60	66	70	74
Change		16%	14%	19%	20%	10%	6%	6%
H section	28	30	32	36	40	43	46	48
Change		7%	7%	13%	11%	8%	7%	4%
Pipe	11	12	13.9	14.5	15.9	18	20	21.5
Change		9%	16%	4%	10%	13%	11%	8%
CRC	8	10	12	16	21	34	44	55
Change		25%	20%	33%	31%	62%	29%	25%
CRC strip	2	3	4	5	6	7	9	11
Change		50%	33%	25%	20%	17%	29%	22%
Gal	3	4	6.9	9.7	14.3	18.5	21.8	24.3
Change		33%	73%	41%	47%	29%	18%	11%
Color coated	0.5	1.5	2.3	4.1	9	10.5	11.4	12.8
Change		200%	53%	78%	120%	17%	9%	12%

Source: Custeel.

Table 5 shows that capacity for downstream products—such as HRC and CRC—is likely to continue to grow strongly in 2006 and 2007. However, crude capacity growth would slow down significantly. China was a net crude steel exporter in 2004 and 2005, and if crude capacity growth slows down, downstream product growth will unavoidably slow down eventually.

Our field investigations and interviews with steel makers confirm a slow growth of crude capacity build-up. Many steel makers have no crude steel capacity expansion in progress or anything planned in the near future.

To conclude, we believe that steel prices might remain range-bound in 2006 as higher input costs would limit downside risk and capacity overhang would likely cap the upside. However, gradually, demand would catch up with capacity growth and lead to a balanced steel market in China. We believe this would be a very positive factor in global and China's steel prices.

Feng Zhang
(852) 2800 8513
feng.zhang@jpmorgan.com

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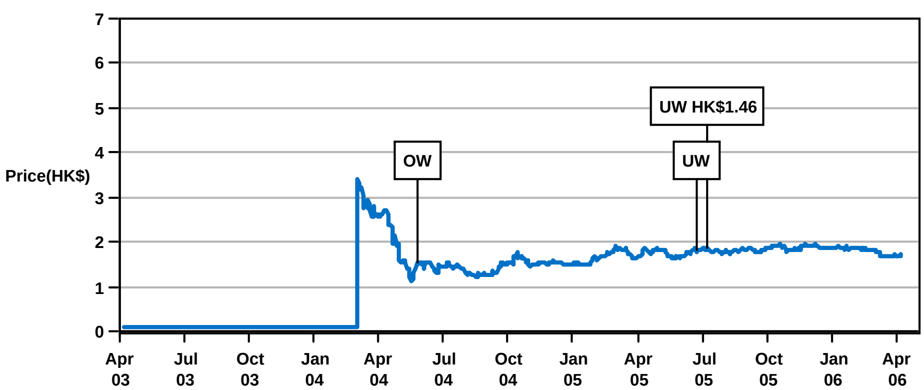

Date	Rating	Share Price (HK$)	Price Target (HK$)
24-May-04	OW	1.53	-
23-Jun-05	UW	1.82	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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Revised April 3, 2006.

Feng Zhang
(852) 2800 8513
feng.zhang@jpmorgan.com

China Oriental: Summary of financials

Profit and Loss statement					
CNY in millions, year-end Dec	FY03A	FY04A	FY05A	FY06E	FY07E
Revenues	5,278	9,119	9,183	9,877	10,905
% change Y/Y	105.3	72.8	0.7	7.6	10.4
Gross Margin (%)	23.3	14.4	13.3	8.9	13.5
EBITDA	1,263	1,378	1,378	1,090	1,561
% change Y/Y	87.1	9.1	0.0	-20.9	43.1
EBITDA Margin (%)	23.9	15.1	15.0	11.0	14.3
EBIT	1,167	1,229	1,081	758	1,198
% change Y/Y	93.1	5.3	-12.0	-29.9	58.1
EBIT Margin (%)	22.1	13.5	11.8	7.7	11.0
Net Interest	-31	-64	-74	-82	-82
Earnings before tax	1,143	1,171	1,005	674	1,114
% change Y/Y	94.9	2.5	-14.2	-32.9	65.3
Tax	40	30	157	101	167
as % of EBT	-3.5	2.6	-15.6	-15.0	-15.0
Net Income (Reported)	1,076	1,173	847	590	938
% change Y/Y	177.4	9.0	-27.8	-30.4	59.1
Shares Outstanding	2100	2770	2905	2905	2905
EPS (reported)	0.513	0.424	0.292	0.203	0.323
% change Y/Y	177.4	-17.4	-31.2	-30.4	59.1

Cash flow statement					
CNY in millions, year-end Dec	FY03A	FY04A	FY05A	FY06E	FY07E
EBIT	1,167	1,229	1,081	758	1,198
Depreciation & amortisation	97	150	297	333	363
Change in working capital	-390	-469	269	-344	-37
Taxes	-40	30	-157	-101	-167
Cash flow from operations	290	393	620	578	1,264
Capex	-429	-401	-850	-600	-500
Disposal/ (purchase)	1	0	0	0	0
Net Interest	-31	-64	-74	-82	-82
Free cash flow	-139	-8	-230	-22	764
Equity raised/ (repaid)	0	2,107	0	0	0
Debt raised/ (repaid)	522	-500	-249	0	0
Other	131	41	-95	0	0
Dividends paid	-370	-480	-625	-136	-118
Beginning cash	118	153	2,925	1,725	1,568
Ending cash	153	2,925	1,725	1,568	2,213
DPS	0.229	0.226	0.047	0.041	0.065

Balance sheet					
CNY in millions, year-end Dec	FY03A	FY04A	FY05A	FY06E	FY07E
Cash and cash equivalents	153	2,925	1,725	1,568	2,213
Accounts receivable	267	828	714	768	848
Inventories	691	900	1,103	1,248	1,308
Others	720	412	253	272	300
Current assets	1,831	5,065	3,796	3,855	4,669
LT investments	0	0	0	0	0
Net fixed assets	1,173	2,349	4,236	4,504	4,641
Total assets	3,060	7,482	8,153	8,753	9,651
Liabilities					
ST loans	322	1,420	1,336	1,336	1,336
Payables					
Others	1,584	1,577	1,929	1,798	1,921
Total current liabilities	2109	2997	3112	3272	3410
Long term debt	683	459	294	294	294
Other liabilities	319	25	15	0	0
Total liabilities	3111	3481	3421	3566	3704
Shareholders' equity	946	3885	4593	5048	5808
BVPS	0.450	1.403	1.581	1.738	1.999

Ratio Analysis					
%, year-end Dec	FY03A	FY04A	FY05A	FY06E	FY07E
EBITDA margin	23.9	15.1	15.0	11.0	14.3
Operating margin	22.1	13.5	11.8	7.7	11.0
Net profit margin	20.4	12.9	9.2	6.0	8.6
SG&A/sales	23.9	15.1	15.0	11.0	14.3
Sales per share growth	105.3	72.8	0.7	7.6	10.4
Sales growth	105.3	72.8	0.7	7.6	10.4
Net profit growth	177.4	9.0	-27.8	-30.4	59.1
EPS growth	177.4	-17.4	-31.2	-30.4	59.1
Interest coverage (x)	41.0	21.4	18.6	13.4	19.1
Net debt to total capital	21.0	-14.2	-1.2	0.7	-6.1
Net debt to equity	90.1	-26.9	-2.1	1.2	-10.0
Sales/assets	172.5	121.9	112.6	112.8	113.0
Assets/equity	323.5	192.6	177.5	173.4	166.2
ROE	113.8	30.2	18.4	11.7	16.1
ROCE	59.8	21.3	17.4	11.3	16.1

Source: Company, JPMorgan estimates.