DAIWA
DAIWA INSTITUTE OF RESEARCH LTD.

29 June 2006 (No. of pages: 11)

China Oriental Group (581 HK)

6-mth rating: **1**
Share price (27 Jun): HK$3.25
Target price: HK$3.80

Materials: China

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Capacity expansion to boost earnings prospects

- We have raised our six-month target price for China Oriental Group (COG) from HK$3.20 to HK$3.80, which is based on COG's own peak-cycle valuation of a 5.9x PER. Since our target price offers 17% upside potential from the current share price, we maintain our **1** (*Buy*) rating.

- COG announced recently that it plans to add one more H-section steel mill with a production capacity of 1.2m tpa, boosting its capacity by 25-30% to around 5.2m tpa from 4m tpa currently. The new capacity addition, which we expect to materialise by mid-2008, would ensure the company's earnings-growth momentum remains strong, in our view. We have reviewed our earnings forecasts, and revised up those for FY08 and FY09 by 16% YoY and 31% YoY, respectively.

- Nevertheless, despite the strong increase in the ASP in 1H07, we expect the rising cost of production to be a drag on earnings growth for the year. For FY08 earnings, we see the key downside risks as an unexpected fall in steel prices or a higher-than-expected rise in the cost of raw materials, such as iron ore. Currently, we hold the view that FY08 steel prices would be stable at the FY07 level.

Market data

HSI		21,705.56
Market cap	(US$mn)	1,209
EV	(Rmb$m; 06)	9,452
3-mth avg daily T/O	(US$m)	16.9
Shares outstanding	(m; 06)	2,905
ROE	(%; 06)	18.8
ROA	(%; 06)	12.6
Net debt/equity	(%, 06)	4.5
Exchange rate	HK$/US$	7.81

Investment indicators

PER	(x; 07F)	5.9
	(x; 08F)	5.1
PCFR	(x; 07F)	5.8
	(x; 08F)	4.2
EV/EBITDA	(x; 07F)	4.1
	(x; 08F)	2.8
PBR	(x; 06)	1.7
Dividend yield	(%; 07F)	2.8

Source: Daiwa forecasts

Income summary

	Revenue		EBITDA		Net profit		EPS	CFPS	DPS
Year to 31 Dec	**(Rmb m)**	**(%)**	**(Rmb m)**	**(%)**	**(Rmb m)**	**(%)**	**(Rmb)**	**(Rmb)**	**(Rmb)**
2005	9,182.7	1	1,282.0	(2)	846.6	(28)	0.291	0.581	0.047
2006	9,782.1	7	1,667.9	30	1,032.8	22	0.356	0.875	0.058
2007F	13,066.3	34	2,280.4	37	1,569.7	52	0.540	0.559	0.090
2008F	15,101.8	16	3,140.2	38	1,822.3	16	0.627	0.779	0.105
2009F	16,923.1	12	3,973.3	27	2,389.3	31	0.822	0.929	0.138

Source: Company, Daiwa forecasts

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A new H-section line coming on stream

Capacity expansion to boost earnings prospects

COG announced in May that its 97.6% indirectly-owned subsidiary, Jinxi Ltd (Hebei Jinxi Iron and Steel Company Limited), plans to construct a new H-section steel-rolling line with an annual capacity of 1.2m tonnes of H-section steel. As COG is still under a blackout period due a general offer from its second-largest shareholder, it could not provide us with more information with regards to when the project is likely to be completed and commissioned. According to what it disclosed in the announcement, the company has entered into various project contracts with more than 23 independent parties since January 2007 up to the date of announcement. Therefore, assuming a normal 18-month project-construction cycle, we expect this H-section line to be commissioned fully in mid-2008.

Upward revisions to our sales-volume forecasts

Therefore, in view of the addition of new H-section steel capacity in mid-2008 and after fine-tuning our forecasts for other types of products, we forecast COG's total sales volume to increase by 13% YoY and 14% YoY to 4.25m tpa and 4.85m tpa for FY07 and FY08, respectively, 1% and 8% higher than our previous forecasts.

COG: sales volume (m tonnes)

	2006	2007F	2008F	2009F
Jinxi				
Billets	1.17	0.40	0.40	0.40
Strips	2.20	2.61	2.61	2.61
H-section	0.25	1.00	1.60	2.20
Sub total for Jinxi	3.62	4.01	4.61	5.21
Foshan Jinlan (60% stake)				
CR-steel	0.04	0.09	0.09	0.09
Galvanised sheet	0.08	0.15	0.15	0.15
Sub total for Foshan	0.12	0.24	0.24	0.24
Total sales volume	**3.75**	**4.25**	**4.85**	**5.45**
% YoY	12	13	14	12
Previous forecast		4.2	4.5	n.a.
% changes in forecast		1	8	n.a.

Source: Company, Daiwa forecasts

Steel prices rose strongly in 1H07

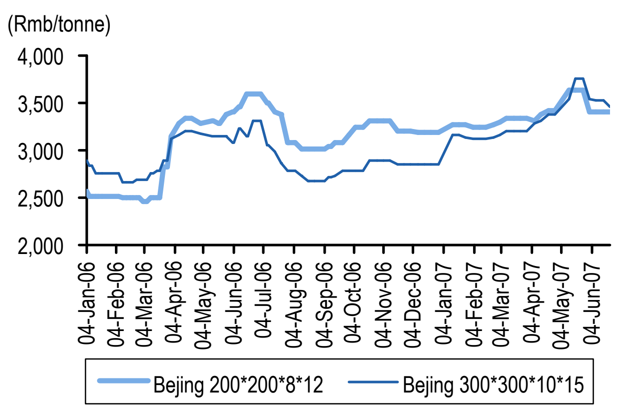
During 1H07, H-section prices increased by 34-36% YoY, strip prices rose by 8-10% YoY and billet prices were up 9% YoY, as set out in the following table.

China: spot prices (Rmb/tonne)

Rmb/tonne (excl. VAT)	Small H-section (BJ)	Large H-section (BJ)	Narrow strips (Tangshan)	Wide strips (Tianjin)	Billets (Tangshan)
1H06 average	2,934	2,950	2,535	2,699	2,369
2H06 average	3,197	2,829	2,571	2,785	2,377
FY06 average	3,065	2,889	2,553	2,742	2,373
1H07 average	3,991	3,943	2,778	2,918	2,581
% YoY	36.0	33.7	9.6	8.1	8.9
% comparing to FY06 from 1H07	30.2	36.5	8.8	6.4	8.8

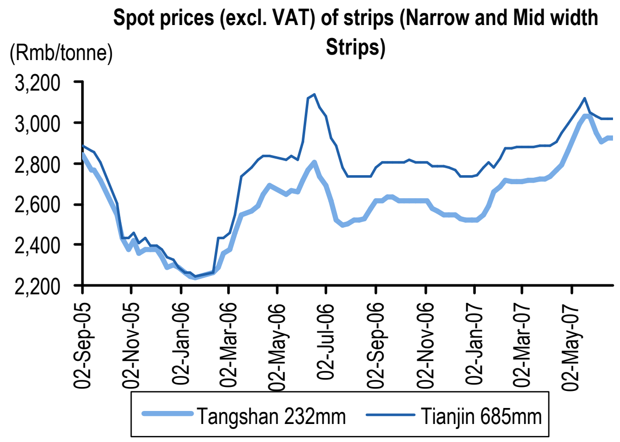
Source: Custeel

China: spot H-section prices (Rmb/tonne)



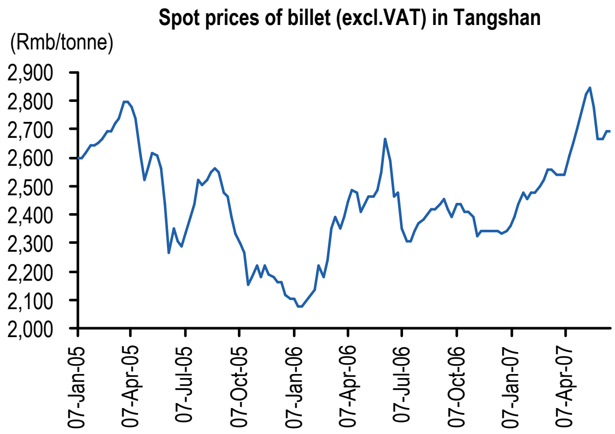
Source: Custeel

China: spot strip prices (Rmb/tonne)



Source: Custeel

China: spot billet prices (Rmb/tonne)



Source: Custeel

Upward ASP-forecast revisions

Therefore, in view of stronger-than-expected prices, we have revised up our ASP forecasts for each type of product. We now forecast the prices of COG's billets and strips to increase by 7% YoY for FY07, versus our forecasts of a 5% YoY increase for each previously.

For H-section steel, we now expect a 25% YoY increase in the FY07 ASP, in view of price increase of more than 30% YTD for FY07 in the spot market, versus our previous forecast of an 8% YoY rise.

Overall, we forecast COG's ASP to increase by 18% YoY for FY07, but remain flat in FY08 and FY09, in view of a more balanced demand-and-supply picture in the China steel market (for a more detailed view on China steel market, please refer to our forthcoming sector report).

COG: ASP (Rmb/tonne)

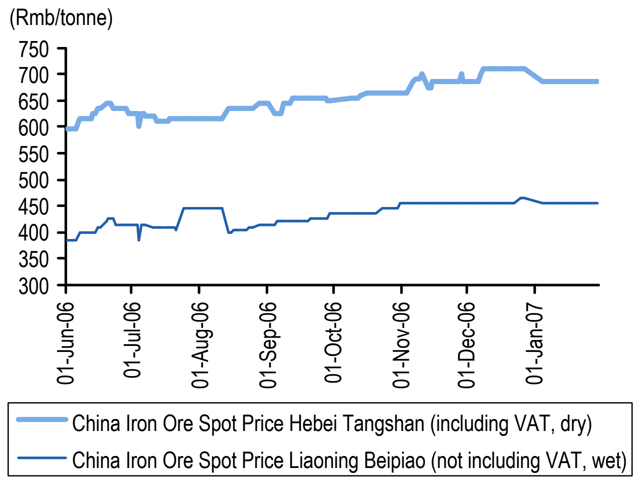
ASP (ex. VAT)	**2006**	**2007F**	**2008F**	**2009F**
Billets	2,347	2,511	2,486	2,436
Strips	2,600	2,782	2,754	2,699
H-section	2,917	3,646	3,610	3,538
Cold-rolled steel	3,578	3,757	3,719	3,645
Galvanized steel	4,959	5,207	5,155	5,052
Total ASP	**2,611**	**3,074**	**3,114**	**3,105**
Previous forecast		**2,823**	**2,879**	**2,915**
% changes in forecast		**9**	**8**	**7**
ASP % YoY				
Billets	0	7	(1)	(2)
Strips	0	7	(1)	(2)
H-section	0	25	(1)	(2)
Cold-rolled steel	0	5	(1)	(2)
Galvanized steel	0	5	(1)	(2)
Total ASP	**(5)**	**18**	**1**	**0**

Source: Company, Daiwa forecasts

Rising cost of raw materials in 1H07

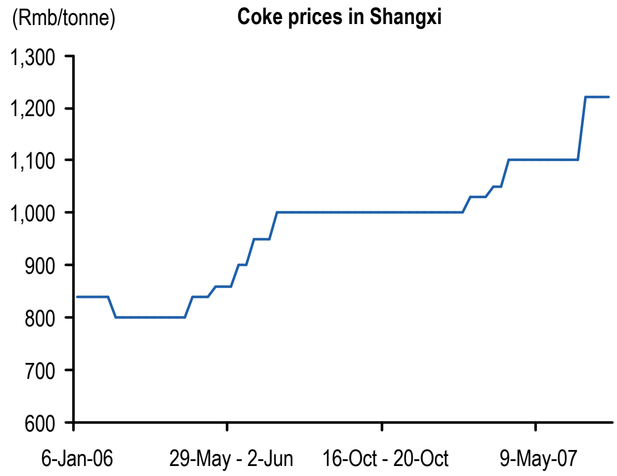
During 1H07, average domestic iron-ore prices increased by 8% to Rmb700/tonne, compared with those for 2H06. Average coke prices in 1H07 increased by 21% to Rmb1,115/tonne, compared with those for FY06.

Domestic iron-ore prices (Rmb/tonne)



Source: Bloomberg

Domestic coke prices (Rmb/tonne)



Source: Custeel

Upward revisions to our unit-cost-of-production forecasts

Therefore, we have revised up our forecasts for the unit cost of production by 13% for both FY07 and FY08. The revisions are based on a 13% YoY increase in cost of raw materials, which include iron ore, scrap steel, coke etc, and a 20% YoY increase in fuel costs, because coal prices have also increased in line with rising coke prices.

Unit cost of production to decline in FY08 and FY09

For FY08, we have factored in a 4% YoY decline in the cost of raw materials, driven mainly by the increase in production scale, despite a 10% YoY increase in our forecast for imported iron-ore prices. We believe there is room for a further 5% YoY decrease in FY09, in view of Daiwa's forecast of a 10% YoY decline in imported iron-ore prices for FY09.

COG sources 80% of its domestic iron-ore supply from Hebei Province. Therefore, it is less exposed to rising iron-ore freight costs than the other giant steel mills, such as Baosteel, Angang and Magang. Nevertheless, domestic iron-ore prices would still rise with the increase in CIF iron-ore cost, which includes the freight cost. Therefore, as noted before, domestic iron-ore prices have increased by 8% since 2H06.

COG: unit COGS (Rmb/tonne)

	2006	2007F	2008F	2009F
Raw materials	1,778	2,009	1,929	1,832
Aux materials	198	198	198	198
Energy & utilities	160	192	192	192
Depreciation	78	82	82	82
Staff costs	48	50	50	50
R&M	25	25	25	25
Total unit COGS	**2,287**	**2,556**	**2,476**	**2,379**
Previous forecast		2,265	2,200	2,134
% changes in forecast		**13**	**13**	**12**
Unit COGS % YoY				
Raw materials	(9)	13	(4)	(5)
Aux materials	(7)	0	0	0
Energy & utilities	15	20	0	0
Depreciation	30	5	0	0
Staff costs	33	5	0	0
R&M	(19)	0	0	0
Total unit COGS	**(4)**	**1**	**(3)**	**(4)**

Source: Company, Daiwa forecasts

Earnings-forecast revisions and valuation

FY07 earnings forecast revised down due to rising cost of production

Despite the rise in ASPs for 1H07, the increase in the cost of raw materials (especially those for iron ore, coke and fuels) has eaten into the company's FY07 net profit. Therefore, we have revised down our FY07 earnings forecast by 8% to Rmb1,570m.

FY08 earnings forecast revised down slightly by 1%

For FY08, despite revising up our forecast for the unit cost of production by 13%, we expect the company's ASPs to hold up pretty well (we have factored in a slight year-on-year decline of 1% YoY into our forecast). Therefore, we have revised down our earnings forecast for FY08 by just by 1% to Rmb1,832m, and now forecast 52% YoY and 16% YoY increases in earnings for FY07 and FY08, respectively.

We expect FY09 earnings to be driven by capacity expansion

We expect FY09 earnings to resume robust growth, in view of the full commission of the new H-section line of 1.2m tpa, as well as a 10% YoY decline in imported iron-ore prices, according to our house forecasts.

Earnings boost if tax unification takes place in FY08

In addition, assuming COG would enjoy a 25% tax rate from FY08 onwards if the tax unification is implemented by then, we estimate COG's FY08 and FY09 earnings would be boosted to Rmb2,068m and Rmb2,713m, up by 32% YoY and 31% YoY, respectively.

COG: earnings-forecast revisions and comparison with the consensus (Rmb m)

	2006	2007F	2008F	2009F
Revenue	**9,782**	**13,066**	**15,102**	**16,923**
% YoY		34	16	12
Previous forecast		11,857	12,955	n.a.
% changes in forecast		10	17	n.a.
Bloomberg forecast		11,730	12,874	n.a.
% variance		11	17	n.a.
Net profit	**1,033**	**1,570**	**1,822**	**2,389**
% YoY		52	16	31
Previous forecast		1,712	1,832	n.a.
% changes in forecast		(8)	(1)	n.a.
Bloomberg forecast		1,552	1,728	n.a.
% variance		1	5	n.a.
EPS (Rmb)	**0.356**	**0.540**	**0.627**	**0.822**
% YoY		52	16	31
Previous forecast		0.589	0.631	n.a.
% changes in forecast		(8)	(1)	n.a.
Bloomberg forecast		0.534	0.595	n.a.
% variance		1	5	n.a.

Source: Company, Bloomberg, Daiwa forecasts

Valuation

Undemanding valuation

The stock is trading currently at a 5.1x PER on our FY08 earnings forecast, which represents a 14% discount to its historical peak-cycle valuation. Since we are of the view that the cycle for the China steel industry will peak in FY08, given that most of the negative catalysts have already emerged in the market and are being digested, and export demand is set to remain strong given the benign global economic situation, we therefore think that COG should be given a full peak-cycle valuation of a 5.9x PER, also taking into account its own solid capacity expansion.

In addition, we are comfortable with COG's valuation representing a discount to other Hong Kong-listed and China-listed integrated steel stocks that are trading currently at PERs of 9-13x, mainly because of its relatively small capacity size and less-optimal product mix compared with those high-end flat-steel makers and given its relatively small market capitalisation.

Still a Buy

We derive our six-month target price of HK$3.80 from a peak-cycle valuation of a 5.9x PER. Since our target price offers 17% upside potential from the current share price, we therefore maintain our 1 rating.

General offer may provide a short-term positive catalyst

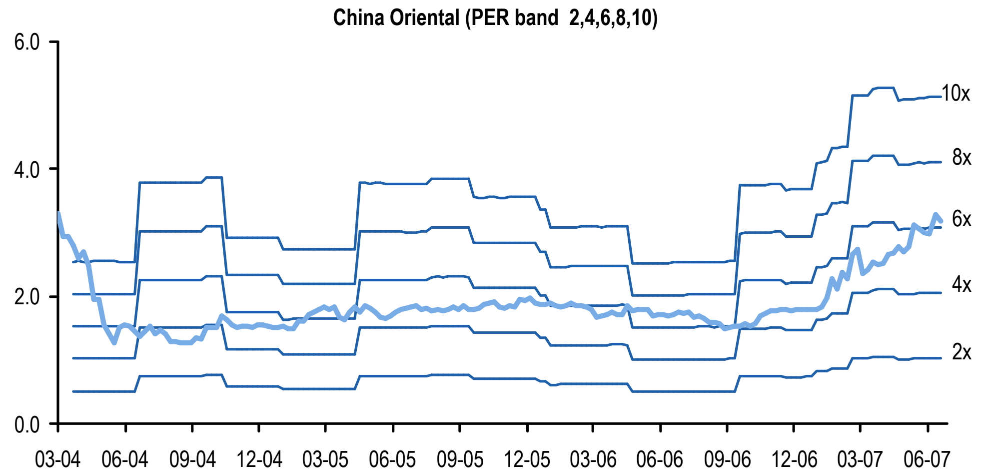
Note that the general offer by the second-largest shareholder (for details, please refer to the appendix) could be a short-term positive catalyst for the share-price performance if the offer of HK$3.00/share is raised.

Peer valuation comparison

Ticker	Company Name	share price	Crncy of stock	Shares outstanding (m shrs)	Current market cap (US$m)	ROE (%)	ROA (%)	Yield (%)	Gross profit margin (%)	Net margin (%)	PER (x)			PBR (x)			EV/EBITDA (x)		
						05	05	05	05	05	06F	07F	08F	06F	07F	08F	06F	07F	08F
Hong Kong-listed steel stocks																			
581 HK	CHINA ORIENTAL	3.250	HK$	2,907.5	1,209.2	20.5	12.6	2	14.6	10.6	6.0	5.4	n.a.	1.2	2.2	2.0	3.5	2.0	2.0
347 HK	ANGANG STEEL-H	16.080	HK$	890.0	1,831.4	34.4	19.4	4	23.9	13.1	11.2	10.1	8.3	2.7	2.3	2.0	8.0	6.3	5.5
323 HK	MAANSHAN IRON-H	6.100	HK$	1,732.9	1,352.8	21.1	11.5	2	12.9	7.0	12.5	9.7	8.5	1.8	1.6	1.4	4.5	3.9	4.9
1053 HK	CHONGQING IRON-H	3.880	HK$	538.1	267.2	6.5	3.0	3	9.0	2.6	16.6	13.9	17.8	n.a.	n.a.	n.a.	2.5	2.2	16.7
2889 HK	CHINA SPEC STEEL	3.260	HK$	1,974.8	823.8	19.8	10.8	4	19.1	10.3	9.3	4.6	4.6	1.8	1.4	n.a.	14.1	4.7	3.2
Total average						**20.5**	**11.5**	**3%**	**15.9**	**8.7**	**11.1**	**8.7**	**9.8**	**1.9**	**1.9**	**1.8**	**6.5**	**4.2**	**3.9**
China-listed steel stocks																			
600019 CH	BAOSHAN IRON & S	10.990	Rmb	17,512.0	25,267.4	17.0	8.9	7	17.8	8.3	12.6	11.0	10.9	2.1	1.9	1.8	5.7	5.3	5.7
600005 CH	WUHAN IRON & S-A	10.230	Rmb	7,838.0	10,527.1	18.5	10.2	3	16.9	9.5	15.2	12.2	10.1	3.3	2.9	2.6	8.4	8.1	6.6
000898 CH	ANGANG STEEL-A	18.570	Rmb	5,043.0	12,295.0	34.4	19.4	3	23.9	13.1	13.5	11.1	9.4	3.5	3.0	n.a.	8.3	6.5	n.a.
600808 CH	MAANSHAN IRON-A	7.200	Rmb	4,722.4	4,464.0	12.3	5.1	2	12.9	7.0	14.6	11.6	11.0	2.3	1.9	n.a.	9.0	6.3	7.0
000709 CH	TANGSHAN IRON-A	13.610	Rmb	2,266.3	4,049.5	16.3	5.4	3	13.1	5.2	17.5	14.4	n.a.	2.7	2.7	n.a.	14.9	14.9	n.a.
000961 CH	DALIAN JINNIU-A	7.840	Rmb	300.5	309.3	1.3	0.4	0	6.6	0.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
600399 CH	FUSHUN SPECIAL-A	8.670	Rmb	520.0	591.9	1.0	0.3	0	7.8	0.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
600117 CH	XINING SPEC ST-A	7.850	Rmb	693.2	714.4	11.0	3.4	0	18.1	6.7	16.6	14.0	11.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
000708 CH	DAYE SPECIAL S-A	12.690	Rmb	449.4	748.7	27.7	10.4	0	8.7	7.0	24.4	21.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
600282 CH	NANJING IRON-A	16.190	Rmb	936.0	1,989.5	11.1	4.4	1	6.5	2.5	17.6	14.1	14.0	3.9	3.4	2.9	n.a.	n.a.	n.a.
000825 CH	SHANXI TAIGANG-A	21.990	Rmb	3,458.5	9,984.9	25.9	9.2	1	14.1	6.1	15.4	12.7	12.4	5.0	4.3	3.0	24.8	23.2	5.3
000717 CH	SGIS SONGSHAN CO	8.030	Rmb	1,341.1	1,413.9	8.1	3.4	1	7.0	3.4	16.4	18.1	10.6	1.9	1.8	1.5	12.6	12.6	n.a.
Total average						**15.39**	**6.7**	**2%**	**12.8**	**5.8**	**16.4**	**14.0**	**11.2**	**3.2**	**2.7**	**2.4**	**11.5**	**10.3**	**6.1**
China/HK total average						18.1	9.1	2	14.3	7.3	13.7	11.4	10.5	2.5	2.3	2.1	9.0	7.3	5.0

Source: Bloomberg

COG: PER bands (x)

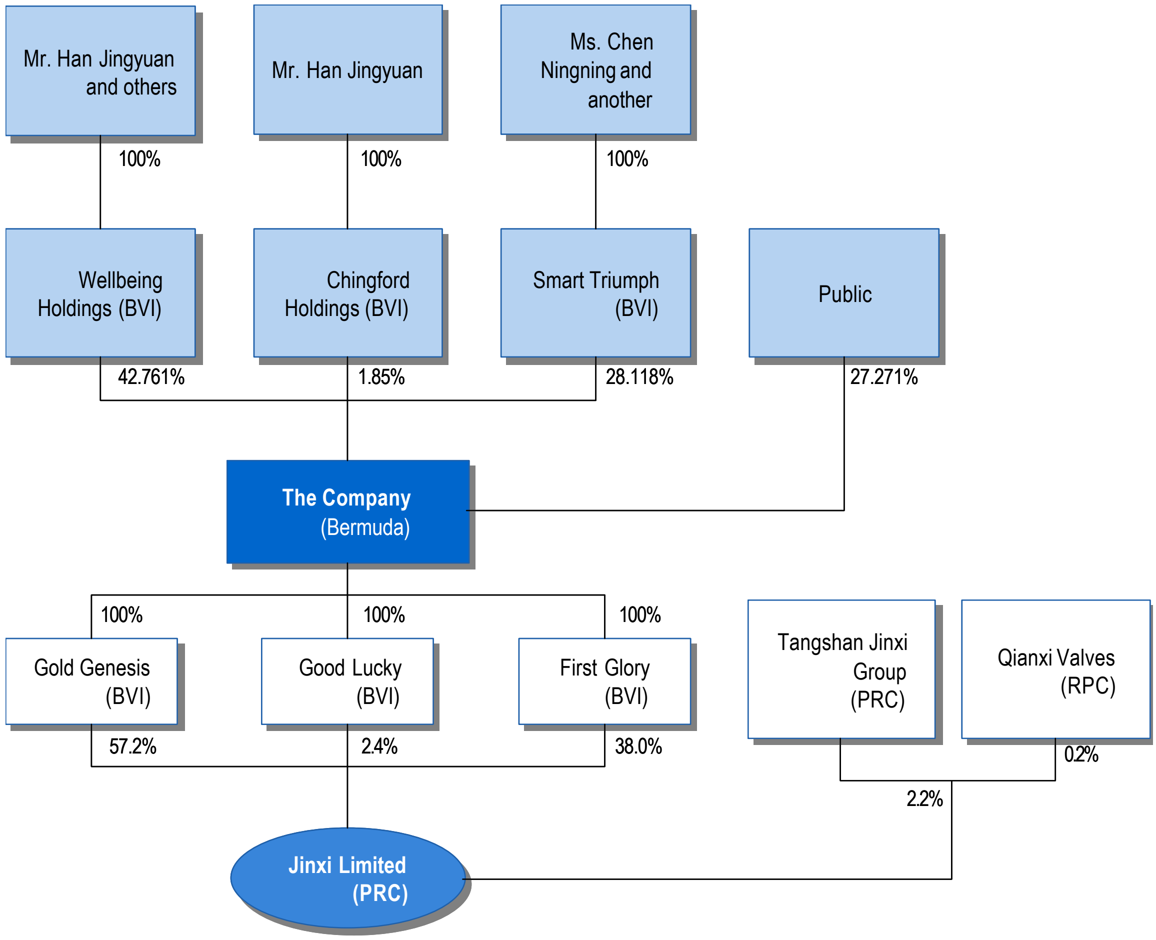


Source: Bloomberg

Appendix: general offer from the second-largest shareholder

Smart Triumph (ST) said in a recent announcement that it would pay HK$18, plus two exchangeable bonds with a face value of HK$4.50, for every nine shares held. In other words, the offer consideration per share is HK$3.00 per share. ST currently has a 28.11% stake in COG.

COG: shareholding structure



Source: Company

According to COG management, the company has hired an independent financial adviser to evaluate the offer terms, and would give a response (yes or no) to the offer in due course.

Compared with the current share price of HK$3.25 per share, the offer consideration of HK$3.00 represents an 8% discount.

We estimate a fair offer consideration would be Rmb3.7/share, taking into consideration that it should be based on COG's peak-cycle valuation of a 5.9x PER on our FY08 earnings forecast and a 10x PER on our FY06 earnings forecast.

COG: valuation

Offer consideration per share	(HK$)	3		
Shares outstanding	(m)	2,905		
Valuation of COG from offeror	**(HK$m)**	**8,715**		
HK$/Rmb		0.9748		
		2006	2008F Daiwa	2008F Bloomberg Consensus
COG's net income	(Rmb m)	1,033	1,822	1,728
PER		**8.2**	**4.7**	**4.9**
PER paid by FerroChina to acquire associate		10.2		
Peak-cycle valuation of COG		5.9		
Fair value of COG using a 10x PER	(HK$m)	10,809		
Fair offer consideration per share	**(HK$)**	**3.7**		
Fair value of COG using a 5.9x forward PER on the Bloomberg-consensus forecast	(HK$m)	10,459		
Fair offer consideration per share	**(HK$)**	**3.6**		
Fair value of COG using a 5.9x forward PER on Daiwa forecast	(HK$m)	11,029		
Fair offer consideration per share	**(HK$)**	**3.8**		
Average fair offer consideration per share	**(HK$)**	**3.7**		
Premium to its existing offer consideration (%)		**24**		
Premium to share price of HK$3.25 closing on 27 June (%)		**14**		

Source: Daiwa estimates, Bloomberg

China Oriental Group – financial summary

Profit and loss (Rmb m)

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Revenue	9,183	9,782	13,066	15,102	16,923
Operating expenses	(7,901)	(8,114)	(10,786)	(11,962)	(12,950)
EBITDA	1,282	1,668	2,280	3,140	3,973
Depreciation & amortisation	(263)	(309)	(309)	(309)	(308)
EBIT	1,019	1,359	1,971	2,831	3,665
Interest income	66	-	24	20	31
Interest expenses	(79)	(125)	(124)	(123)	(122)
Net interest income/(expenses)	(12)	(125)	(100)	(103)	(91)
Associates/JV	(2)	(1)	(1)	(1)	(1)
Profit before tax	1,004	1,233	1,871	2,727	3,574
Tax paid	(157)	(211)	(296)	(900)	(1,179)
Minorities	(1)	10	(5)	(5)	(5)
Net profit	847	1,033	1,570	1,822	2,389

Cash flow (Rmb m)

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Pre-tax profit	1,004	1,233	1,871	2,727	3,574
Depreciation/amortisation	208	327	411	411	411
Associate adjustment	2	1	1	1	1
Change in working capital	694	1,174	(461)	(286)	(256)
Tax paid/credited	(244)	(204)	(206)	(598)	(1,040)
Other operating	7.3	0.0	0.0	0.0	0.0
Operating cash flow	**1,672**	**2,531**	**1,615**	**2,255**	**2,690**
Capital expenditure	(854)	(587)	(1,500)	(1,500)	(1,500)
Investments	(24.2)	0.0	0.0	0.0	0.0
Asset/invest disp at selling price	4.0	8.1	0.0	0.0	0.0
Equity raised	0.0	0.0	0.0	0.0	0.0
Dividend paid	(146.3)	(165.8)	(132.1)	0.0	0.0
Other investment/equity	(3,743.3)	(3.0)	0.0	0.0	0.0
Net chg in cash	**(3,091.8)**	**1,784.2**	**(17.1)**	**755.4**	**1,190.1**

Balance sheet (Rmb m)

As at 31 Dec	2005	2006	2007F	2008F	2009F
Fixed assets					
Tangible	4,346	4,792	5,874	6,955	8,037
Associates/JV	9	8	7	6	5
Others	2.3	0.0	0.0	0.0	0.0
Current assets					
Cash & equivalent	1,725	530	983	1,546	2,544
Accounts receivable/debtors	714	999	1,334	1,542	1,728
Inventories	1,103	1,408	1,881	2,174	2,436
Other current assets	253	484	646	746	836
Current liabilities					
Current debts	1346	573	1136	1036	936
Accounts payable	632	516	690	797	893
Others	1133	1114	1539	2048	2374
Non-current liabilities					
Long-term debt	294	361	261	161	61
Other	15	56	56	56	56
Net assets	**4,732**	**5,601**	**7,044**	**8,871**	**11,266**
Financed by:					
Share capital	2,460	2,460	2,460	2,460	2,460
Reserves	2,133	3,019	4,456	6,279	8,668
Shareholders' funds	4,593	5,479	6,917	8,739	11,128
Minority interests	139	122	127	132	137
Net assets	**4,732**	**5,601**	**7,044**	**8,871**	**11,266**

Ratios

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Operating margin (%)	11.8	13.1	14.9	18.5	21.5
Acct receivable turnover (days)	28.4	37.3	37.3	37.3	37.3
EBITDA margin (%)	14.0	17.1	17.5	20.8	23.5
Net debt-to-equity ratio (%)	net cash	4.5	3.7	net cash	net cash
EBITDA/gross interest expenses (x)	16.3	13.4	18.4	25.6	32.7
ROE (%)	18.4	18.8	22.7	20.9	21.5
Dividend payout (%)	16.1	16.1	16.1	16.1	16.1
ROA (%)	10.4	12.6	14.6	14.1	15.3

Source: Company, Daiwa forecasts

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