

China Steel Sector

Earnings to turn around

- **We remain positive on China's steel sector.** We expect China's spot steel prices to increase by 5% and 2% Y/Y in 2007E and 2008E, respectively, on the back of improving fundamentals. We also expect steel companies' earnings to turn around and resume growth. Our top picks are Maanshan (OW), Baosteel (OW), and China Oriental (OW).
- **Capacity growth slowdown to drive up steel prices.** We expect China's steel crude capacity growth to slow down to about 9% in 2006E and 2007E each, and demand to outstrip capacity growth at about 10-15% Y/Y. The slowdown in capacity growth is evident in China's fixed asset investment in steel, which declined by 1% Y/Y during January-August 2006. Given that 25% of crude steel capacity in China falls into the category of "obsolete" capacity and the slowdown of new capacity expansion, the outlook of steel prices is bright in the next two years.
- **Catalysts, share price drivers:** China's spot prices are falling due to weak export orders. This might cause weakness in share prices in the short term. But we expect exports to pick up in 1H07 as international steel prices stabilize due to production cuts. Steel makers in the US and EU have recently announced a cut in production to pre-empt supply glut.
- **Price target, valuation, key risks:** Trading at about 0.6-0.9x FY07E P/B with an ROE of 14-21%, dividend yield of 5-7% and 2-5x FY07E EV/EBITDA, steel names are poised to appreciate significantly next year as prices rise. Key risk is weaker-than-expected steel prices.

China steel sector: Financials

	Maanshan			Baosteel			China Oriental		
	2006E	2007E	2008E	2006E	2007E	2008E	2006E	2007E	2008E
Net sales(RmbMM)	32,738	40,366	54,728	155,195	159,223	160,322	10,817	11,764	11,973
EPS (Rmb)	0.31	0.43	0.67	0.69	0.77	1.0	0.34	0.42	0.54
EPS change (%)	-31	37	57	-4	12	29	15	25	29
BPS (Rmb)	2.9	3.2	3.6	4.6	5.1	5.6	1.8	2.2	2.6
DPS (Rmb)	0.12	0.17	0.27	0.32	0.35	0.45	0.07	0.08	0.11
P/E (x)	10.2	7.5	4.8	7.6	6.8	5.3	5.1	4.1	3.2
P/B (x)	1.1	1.0	0.9	1.1	1.0	0.9	0.9	0.8	0.6
ROE (%)	11	14	20	16	16	19	20	21	22
EV/EBITDA (x)	6.4	5.4	3.4	3.9	3.3	2.5	3.1	2.1	1.1
Dividend yield (%)	4	5	8	6	7	9	4	5	6
Net debt/equity (%)	75	87	66	37	24	10	-4	-16	-30

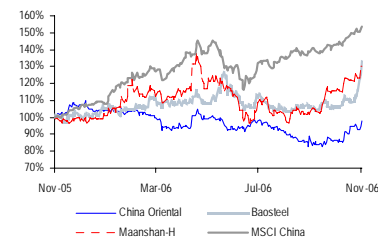
Source: JPMorgan estimates. Note: Prices and valuations are as of November 2, 2006.

Steel

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One year share performance



Source: Datastream.

J.P. Morgan Securities (Asia Pacific) Limited

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China steel market: Positive steel prices outlook

We expect China's steel prices to increase by 5% Y/Y in 2007E and 2% Y/Y in 2008E as crude steel capacity growth is expected to slow down to about 6-9% Y/Y in 2006-08E from about 20%+ Y/Y from 2003-05.

The slowing capacity growth can also be seen from the fixed asset investment in the Chinese steel industry. In the first eight months of 2006, China's fixed asset investment in steel fell by 1% Y/Y, implying a slowdown in capacity growth.

Table 1: China steel supply and demand

Million tons

	Crude capacity	Change	Crude production	Change	Utilization rate	Net import	Apparent consumption	Change	HRC price (US\$/t)	Change
2002	230		180		78%	24	203		280	
2003	286	24%	219	22%	77%	36	255	26%	340	21%
2004	356	24%	269	23%	76%	13	283	11%	470	38%
2005	432	21%	348	29%	81%	0	348	23%	440	-6%
2006E	469	9%	418	20%	89%	-22	396	14%	425	-3%
2007E	510	9%	465	11%	91%	-15	450	14%	445	5%
2008E	540	6%	510	10%	94%	-5	505	12%	455	2%

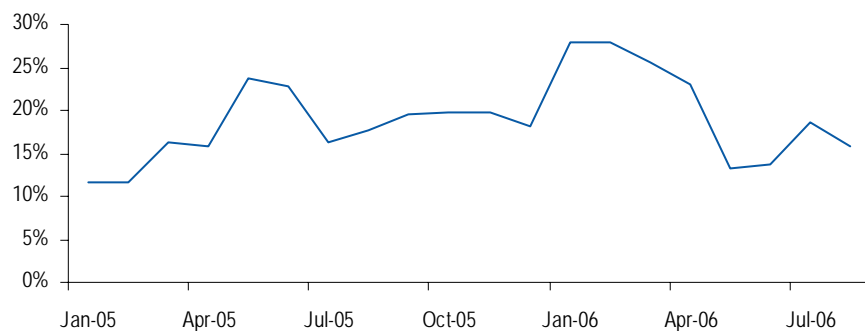
Source: JPMorgan estimates.

Steel demand in China is mainly driven by construction and industrial production, with construction accounting for 50% of steel demand and industrial activity the remaining 50%. China's industrial production (IP) growth is a good indicator of demand from machineries, general industrial and transportation sectors. We expect China's steel demand to slow down to about 12-14% in the next two years from about 20% Y/Y growth in the past three years. 2007 will likely be the first year that China's demand growth will outstrip supply growth in comparison to the past five years.

China's construction growth might slow down but the risk of a crash is slim, given the rapid urbanization and industrialization. Our property team expects about 15% growth in floor space construction in the next two years.

Figure 1: Floor space under construction

000 sq meter

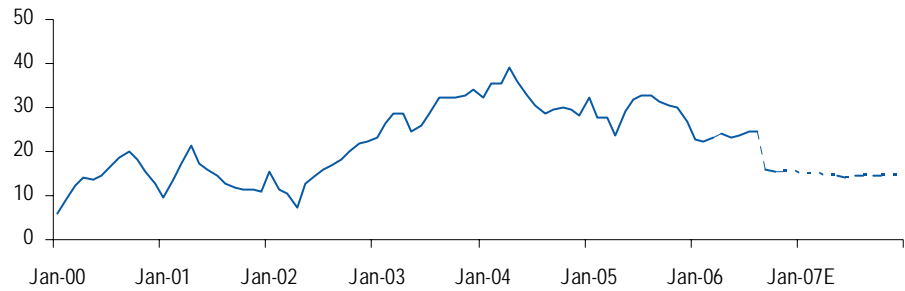


Source: CEIC.

JPMorgan’s economic team expects China’s industrial production growth to slow down but to still maintain a reasonably strong level of about 13% Y/Y in the next two years.

Figure 2: Industrial production growth

YoY 3mma



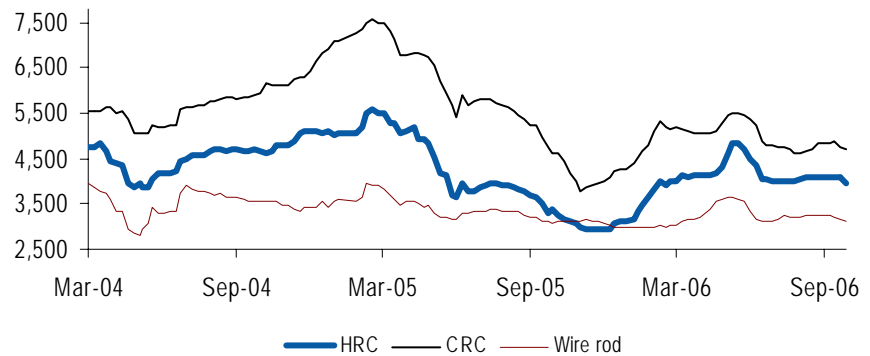
Source: CEIC, JPMorgan estimates.

Spot prices under pressure in the short term

China’s steel prices have fallen by about 4% in the past few weeks. We expect spot steel prices to remain under some pressure in the short term due to weak export orders.

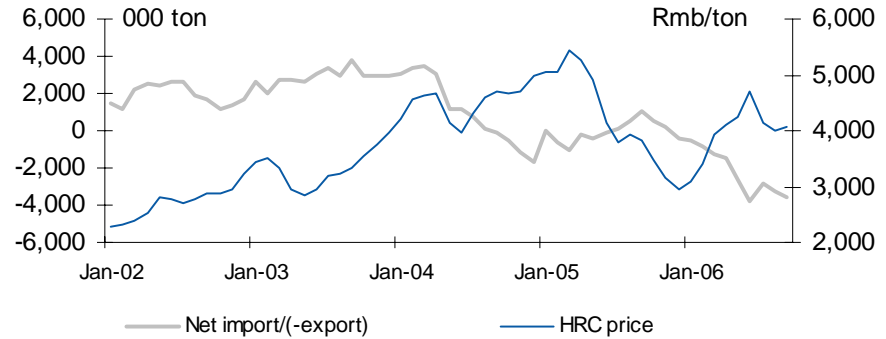
Figure 3: China—Weekly steel prices

Rmb/t incl. VAT



Source: www.mysteel.com.

Figure 4: China—Steel net export and steel price

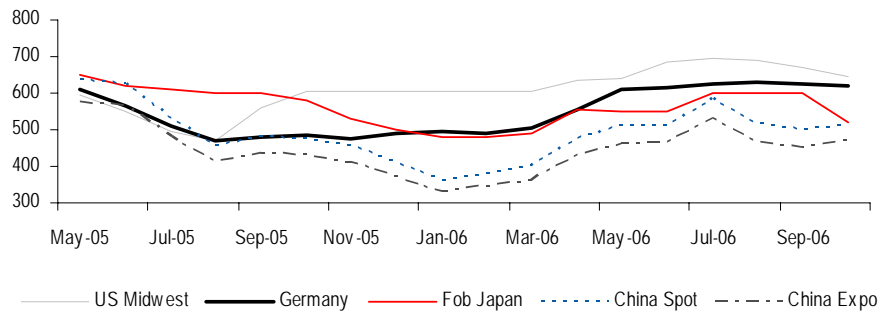


Source: www.mysteel.com.

International steel prices fell in October due to rising exports from China. Steel prices in the US, Germany and Japan fell by 1-13%—Japan being the hardest hit market (down by 13% M/M).

Figure 5: Global steel prices

US\$/t



Source: CRU.

While international markets are absorbing China's exports, we expect international prices, especially US and EU prices, to hold up well in the coming months. The production cut in the US (4% of total US flat production) and EU should help stabilize global steel prices.

Once the US and EU prices stabilize, export orders should increase, and this certainly will help China's spot steel prices to stabilize.

Low inventory in China a positive

Despite rapidly falling prices, inventory remains low in China. We have tracked inventory levels in Shanghai's warehouses since the beginning of this year; the inventory level is at the low end compared to earlier this year.

We think the low inventory actually provides a cushion for steel prices. As traders are cautious on the outlook of steel prices, they do not build up inventory. This shows that the recent sell-off is unlikely to gain momentum on such a low inventory level.

Figure 6: Shanghai—Steel inventory



Source: www.mysteel.com.

Global steel stocks valuations

Global steel stocks are trading at about 4.6x EV/EBITDA and 6.7x FY07E P/E. China's steel stocks are trading at a similar level in terms of P/E but at a large discount to international peers in terms of EV/EBITDA.

China's steel companies are trading at an average of 1.1-1.2x 07E P/B compared to the global companies at 1.6-1.8x.

Table 2: Global comps

	EV/EBITDA			P/E (x)			P/B (x)		
	2005	2006E	2007E	2005	2006E	2007E	2005	2006E	2007E
AK Steel	5.1	4.1	4.4	46.7	9.3	10.6	7.3	5.1	3.5
ArcelorMittal	6.6	5	4.7	8.7	7.5	7.4	2.9	2.1	1.6
BlueScope Steel	5.5	6.3	5.7	7.1	9.3	9.3	1.7	1.6	1.4
Corus	24	22.5	23	0.5	0.1	0.1	NA	2.3	2.1
CSN	5	6.2	4.9	9.4	12.2	9.1	NA	3.4	3.0
Klockner and Co	0	0	0	NM	NM	NM	NA	1.4	1.2
OneSteel	7.9	7.2	5.9	14.4	12.4	9.8	1.6	1.6	1.5
Ternium	4	3	3	4.2	5.4	5	NA	1.5	1.4
ThyssenKrupp	4	3	2.7	12.3	9.3	9.5	NA	NA	NA
US Steel Corp	4.2	3.1	3	10.4	6	5.9	2.4	1.9	1.6
Usiminas	3	3.9	3.3	4.1	5.4	4.3	1.8	1.4	1.1
Voestalpine	7.6	6.2	4.6	15.6	10.8	7.1	2.3	2.0	1.7
Average (simple)	6.4	5.9	5.4	12.1	8.0	7.1	2.9	2.2	1.8
Average(Mkt-weighted)	11.4	10.4	10.2	7.1	5.7	5.2	2.6	2.0	1.6

Source: Company, Bloomberg, JPMorgan estimates. Note: Valuations are as of October 30, 2006.

Table 3: China—Steel companies comps

	EV/EBITDA			P/E			P/B		
	2005	2006E	2007E	2005	2006E	2007E	2005	2006E	2007E
Maanshan-H	4.9	6.4	5.4	7.1	10.2	7.5	1.2	1.1	1.0
Baosteel	3.6	3.9	3.3	7.3	7.6	6.8	1.2	1.1	1.0
China Oriental	3.6	3.1	2.1	6.0	5.1	4.1	1.1	0.9	0.8
Angang-H	7.0	4.7	4.6	11.8	7.6	6.6	2.2	1.8	1.6
Average(Simple)	4.8	4.5	3.8	8.0	7.6	6.2	1.4	1.3	1.1
Average(Mkt-Weighted)	4.8	4.4	3.8	8.6	7.8	6.7	1.5	1.3	1.2

Source: Company, JPMorgan estimates. Note: Valuations are as of November 2, 2006.

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Asia Pacific Equity Research
02 November 2006

Maanshan Iron & Steel

Remain OW with PT of HK\$3.6, 14% upside

Maanshan is planning to complete the capacity expansion by mid-2007. The new capacity expansion is in value-added flat products—HRC and CRC. This will have significant impact on the product mix. After the expansion, high-end flat products will account for over 60-70% of the total volume.

We expect volume sales to go up by 11% Y/Y in 2007E and 35% Y/Y in 2008E.

As a result, we expect earnings to grow by 37% in 2007E, and 57% in 2008E. Although the upcoming issuance of “Bonds with Warrants” might dilute earnings growth slightly (probably 5-10%), we believe Maanshan will still show strong earnings growth on improving steel prices and volume growth.

Table 4: Maanshan—Major assumptions

ASP(Rmb/t)	2003	2004	2005	2006E	2007E	2008E
ASP	2,626	3,426	3,576	3,477	3,620	3,891
Chg %		30%	4%	-3%	4%	7%
HRC(Rmb/t)	3,400	3,700	3,825	3,538	3,688	3,737
Chg %		9%	3%	-8%	4%	1%
Volume sales(finished '000 tons)	5,560	7,430	8,890	9,320	10,320	13,940
Chg %		34%	20%	5%	11%	35%
COGS(Rmb/t)	1,963	2,441	3,024	3,083	3,085	3,323
Chg %		24%	24%	2%	0%	8%
Raw material price(Rmb/t)	955	1,278	1,818	1,821	1,799	1,765
Chg %		34%	42%	0%	-1%	-2%
Iron ore(Rmb/t)	363	401	578	605	602	592
Chg %		11%	44%	5%	-1%	-2%
Coking coal(Rmb/t)	383	555	780	700	680	660
Chg %		45%	41%	-10%	-3%	-3%

Source: Company JPMorgan estimates.

Table 5: Maanshan—What has changed?

	2006E			2007E		
	Old	New	Chg	Old	New	Chg
ASP (Rmb/t)	3,428	3,477	1%	3,575	3,620	1%
HRC (Rmb/t)	3,438	3,538	3%	3,625	3,688	2%
COGS (Rmb/t)	3,054	3,083	1%	3,042	3,085	1%
Raw material price (Rmb/t)	1,792	1,821	2%	1,757	1,799	2%
Iron ore (Rmb/t)	592	605	2%	582	602	3%
Coking coal (Rmb/t)	700	700	0%	680	680	0%
Volume sales (finished '000 tons)	9,320	9,320	0%	10,320	10,320	0%
EPS (Rmb)	0.30	0.31	6%	0.43	0.43	0%

Source: JPMorgan estimates.

Table 6: Maanshan Iron & Steel-H—Summary of financials

Profit and loss statement						Cash flow statement					
CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E	CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E
Revenues	26,770	32,083	32,738	40,366	54,728	EBIT	4,292	3,729	2,995	4,105	5,969
% change Y/Y	70.1	19.8	2.0	23.3	35.6	Depreciation & amortization	1,810	2,065	2,433	3,134	4,723
Gross margin (%)	22.3	14.7	12.2	14.4	15.4	Change in working capital	1,207	1,232	185	237	576
EBITDA	6,173	5,815	5,450	7,239	10,692	Taxes	-461	-415	-384	-524	-820
% change Y/Y	50.3	-5.8	-6.3	32.8	47.7	Cash flow from operations	6,413	6,171	4,654	6,121	9,604
EBITDA margin (%)	23.1	18.1	16.6	17.9	19.5	Capex	-1,257	-900	-2,728	-6,317	-6,317
EBIT	4,292	3,729	2,995	4,105	5,969	Disposal/ (purchase)	33	0	0	0	0
% change Y/Y	44.6	-13.1	-19.7	37.1	45.4	Net interest	-226	-362	-597	-831	-844
EBIT margin (%)	16.0	11.6	9.1	10.2	10.9	Free cash flow	533	758	2,659	3,293	6,359
Net interest	-226	-362	-597	-831	-844	Equity raised/ (repaid)	0	0	0		
Earnings before tax	4,066	3,366	2,397	3,274	5,124	Debt raised/ (repaid)	-489	5,277	5,300	6,954	-6,300
% change Y/Y	42.0	-17.2	-28.8	36.6	56.5	Other	-483	-86	0	0	0
Tax	461	415	384	524	820	Dividends paid	-1,356	-1,420	-1,033	-805	-1,100
as % of EBT	-11.3	-12.3	-16.0	-16.0	-16.0	Beginning cash	2,408	2,173	3,109	2,030	5,299
Net income (reported)	3,592	2,910	2,014	2,750	4,305	Ending cash	2,173	3,109	2,030	5,299	1,502
% change Y/Y	35.1	-19.0	-30.8	36.6	56.5	DPS (CNY)	0.220	0.160	0.125	0.170	0.267
Shares outstanding (MM)	6455	6455	6455	6455	6455						
EPS (reported) (CNY)	0.557	0.451	0.312	0.426	0.667						
% change Y/Y	35.1	-19.0	-30.8	36.6	56.5						

Balance sheet						Ratio analysis					
CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E	%, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E
Cash and cash equivalents	2,173	3,109	2,030	5,299	1,502	EBITDA margin	23.1	18.1	16.6	17.9	19.5
Accounts receivable	2,199	2,215	2,260	2,787	3,779	Operating margin	16.0	11.6	9.1	10.2	10.9
Inventories	4,754	5,168	5,426	6,523	8,748	Net profit margin	13.4	9.1	6.2	6.8	7.9
Others	814	750	726	859	1,110	SG&A/sales	23.1	18.1	16.6	17.9	19.5
Current assets	9,940	11,243	10,443	15,468	15,139	Sales per share growth	70.1	19.8	2.0	23.3	35.6
Long-term investments						Sales growth	70.1	19.8	2.0	23.3	35.6
Net fixed assets	18,728	18,385	22,293	27,206	33,686	Net profit growth	35.1	-19.0	-30.8	36.6	56.5
Total assets	31,196	38,934	45,888	56,779	57,726	EPS growth	35.1	-19.0	-30.8	36.6	56.5
Liabilities						Interest coverage (x)	27.3	16.0	9.1	8.7	12.7
Short-term loans	1,351	2,191	2,191	3,845	2,845	Net debt to total capital	10.6	19.7	30.7	31.3	26.4
Payables						Net debt to equity	21.2	43.8	75.1	87.1	66.4
Others	9,450	9,624	10,898	13,186	17,850	Sales/assets	92.9	91.5	77.2	78.6	95.6
Total current liabilities	10,801	11,816	13,089	17,030	20,694	Assets/equity	199.9	222.7	245.5	279.2	251.8
Long-term debt	4,134	8,571	13,871	19,171	13,871	ROE	24.7	17.6	11.1	14.1	19.9
Other liabilities	580	928	59	59	59	ROCE	21.2	15.1	9.5	10.5	14.4
Total liabilities	15,515	21,314	27,019	36,260	34,624						
Shareholders' equity	15,605	17,482	18,690	20,340	22,923						
BVPS (CNY)	2.417	2.708	2.895	3.151	3.551						

Source: Company, JPMorgan estimates.

Baoshan Iron & Steel

Remain OW with price target of Rmb6.6, 25% upside

Baosteel recently announced its 3Q06 results. EPS came in at Rmb0.27/share, making Jan-Sep EPS at Rmb0.52/share, beating consensus forecast by large margin (consensus expects FY06 EPS of Rmb0.55/share; JPMorgan estimate is Rmb0.57/share).

This is mainly because of higher-than-expected steel prices. We also over-estimated costs of stainless steel products, which account for about 8% of its total production.

Table 7: Baosteel—What has changed?

	FY06E			FY07E		
	Old	New	Change (%)	Old	New	Change (%)
Sales volume (th ton)	20,743	20,953	1%	20,743	20,953	1%
Total ASP(Rmb/ton)	5,240	5,285	1%	5,597	5,414	-3%
Iron Ore (\$/ton)	47	47	0%	49	52	6%
Coking Coal (RMB/ton)	544	544	0%	544	544	0%
Steel production Cost/t	4,690	4,649	-1%	4,824	4,697	-3%
Trade revenue	23,637	33,222	41%	25,245	34,034	35%
SG & A	7,254	7,004	-3%	7,431	6,747	-9%
EPS(Rmb)	0.57	0.69	23%	0.78	0.77	-1%

Source: JPMorgan estimates.

As a result, we raise our FY06 EPS forecast for Baosteel by 23%. Our FY07 EPS forecast remains unchanged as the higher iron ore costs might offset the higher average selling prices. We also introduce an FY08E EPS of Rmb1.0/share, up by 29% Y/Y.

Table 8: Baosteel—Major assumptions

	FY04A	FY05A	FY06E	FY07E	FY08E
Total ASP(Rmb/ton)	4,550	5,461	5,285	5,414	5,452
Chg%		20%	-3%	2%	1%
CRC ASP(Rmb/ton)	4,859	5,929	5,300	5,400	5,500
Chg%		22%	-11%	2%	2%
Sales volume(th ton)	11,590	18,785	20,953	20,953	20,953
Chg%		62%	12%	0%	0%
COGS Rmb/ton	3,575	4,234	4,649	4,697	4,484
Chg%		18%	10%	1%	-5%
Iron ore (Rmb/ton)	396	544	607	618	592
Chg%		37%	12%	2%	-4%
Coking coal price Rmb/ton	594	594	544	544	540
Chg%		0%	-8%	0%	-1%

Source: Company, JPMorgan estimates.

Table 9: Baoshan Iron & Steel—Summary of financials

Profit and loss statement						Cash flow statement					
CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E	CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E
Revenues	58,219	125,914	155,195	159,223	160,322	EBIT	13,973	19,348	18,877	21,300	26,590
% change Y/Y	32.0	116.3	23.3	2.6	0.7	Depreciation & amortization	8,640	14,892	12,617	13,247	13,910
Gross margin (%)	28.8	20.6	16.5	17.5	20.7	Change in working capital	-2,512	-10,603	-122	-122	-122
EBITDA	22,646	34,298	31,552	34,606	40,558	Taxes	-4,147	-5,777	-5,268	-5,872	-7,567
% change Y/Y	24.3	51.5	-8.0	9.7	17.2	Cash flow from operations	16,798	22,722	24,714	26,609	31,563
EBITDA margin (%)	38.9	27.2	20.3	21.7	25.3	Capex	-1,257	-900	-2,728	-6,317	-6,317
EBIT	13,973	19,348	18,877	21,300	26,590	Disposal/ (purchase)					
% change Y/Y	29.2	38.5	-2.4	12.8	24.8	Net interest	-361	-1,198	-1,316	-1,726	-1,366
EBIT margin (%)	24.0	15.4	12.2	13.4	16.6	Free cash flow	533	758	2,659	3,293	6,359
Net interest	-361	-1,198	-1,316	-1,726	-1,366	Equity raised/ (repaid)	0	25,411	0	0	0
Earnings before tax	13,586	19,355	17,562	19,575	25,224	Debt raised/ (repaid)	-4,489	21,301	2,611	-4,400	-10,000
% change Y/Y	36.8	42.5	-9.3	11.5	28.9	Other	747	0	0		
Tax	4,147	5,777	5,268	5,872	7,567	Dividends paid	-4,004	-5,604	-5,604	-6,107	-7,887
as % of EBT	-30.5	-29.8	-30.0	-30.0	-30.0	Beginning cash	1,796	1,581	4,857	8,579	12,681
Net income (reported)	9,395	12,666	12,162	13,571	17,526	Ending cash	1,581	4,857	8,579	12,681	14,358
% change Y/Y	34.7	34.8	-4.0	11.6	29.1	DPS (CNY)	0.320	0.320	0.320	0.349	0.450
Shares outstanding (MM)	12512	17512	17512	17512	17512						
EPS (reported) (CNY)	0.751	0.723	0.694	0.775	1.001						
% change Y/Y	34.7	-3.7	-4.0	11.6	29.1						
Balance sheet						Ratio analysis					
CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E	%, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E
Cash and cash equivalents	1,581	4,857	8,579	12,681	14,358	EBITDA margin	38.9	27.2	20.3	21.7	25.3
Accounts receivable	5,304	13,259	13,181	13,523	13,616	Operating margin	24.0	15.4	12.2	13.4	16.6
Inventories	6,541	25,046	31,966	32,407	31,363	Net profit margin	16.1	10.1	7.8	8.5	10.9
Others	345	3,834	3,834	3,834	3,834	SG&A/sales	38.9	27.2	20.3	21.7	25.3
Current assets	15,954	47,098	57,661	62,547	63,272	Sales per share growth	32.0	116.3	23.3	2.6	0.7
Long-term investments	258	2,828	1,807	1,880	1,953	Sales growth	32.0	116.3	23.3	2.6	0.7
Net fixed assets	48,044	92,098	97,482	96,235	94,325	Net profit growth	34.7	34.8	-4.0	11.6	29.1
Total assets	64,255	142,024	156,950	160,661	159,550	EPS growth	34.7	-3.7	-4.0	11.6	29.1
Liabilities						Interest coverage (x)	62.7	28.6	24.0	20.1	29.7
Short-term loans	5,199	16,394	17,566	14,268	9,779	Net debt to total capital	21.3	22.4	19.5	13.6	6.1
Payables						Net debt to equity	32.6	41.3	36.6	23.9	9.7
Others	6,937	26,285	33,004	33,519	32,638	Sales/assets	93.0	122.1	103.8	100.3	100.1
Total current liabilities	12,136	42,678	50,570	47,788	42,417	Assets/equity	153.5	190.7	193.7	181.5	162.6
Long-term debt	10,106	19,325	20,764	19,662	14,152	ROE	24.3	21.8	15.6	16.0	18.8
Other liabilities	0	887	0	0	0	ROCE	24.9	23.1	16.4	17.6	21.8
Total liabilities	22,242	63,097	71,334	67,450	56,568						
Shareholders' equity	41,861	74,475	81,033	88,497	98,136						
BVPS (CNY)	3.346	4.253	4.627	5.054	5.604						

Source: Company, JPMorgan estimates.

China Oriental

Remain OW with price target of HK\$2.2, 27% upside

China Oriental, a medium-sized steel maker, is located in Northern China's Hebei province. After its strong 1H results in August, we raised our earnings forecasts and rating.

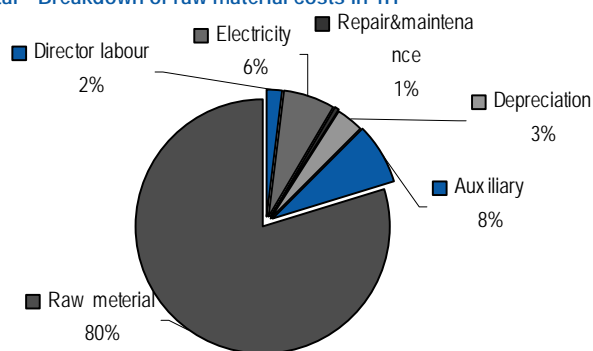
Table 10: China Oriental—Major assumptions

	2003	2004	2,005	2006E	2007E	2008E
ASP(Rmb/t)	2,180	2,694	2,753	2,570	2,668	2,715
Chg %		24%	2%	-7%	4%	2%
Volume sales('000 tons)	2,421	3,385	3,336	4,210	4,410	4,410
Chg %		40%	-1%	26%	5%	0%
COGS(Rmb/t)	1,671	2,307	2,386	2,248	2,251	2,196
Chg %		38%	3%	-6%	0%	-2%
Margin(Rmb/t)	509	387	367	322	417	519
Chg %		-24%	-5%	-12%	29%	25%
Iron ore(Rmb/t)	418	710	735	629	605	556
Chg %		70%	3%	-14%	-4%	-8%
Coking coal(Rmb/t)	809	1,055	1,107	969	885	841
Chg %		30%	5%	-12%	-9%	-5%

Source: Company, JPMorgan estimates.

We remain positive about the company's earnings outlook on improving outlook of steel prices in China. China Oriental buys major raw materials such as iron ore and coke in China. As raw materials account for about 80% of the COGS, the outlook for spot iron ore prices and coke is also important.

Figure 7: China Oriental—Breakdown of raw material costs in 1H

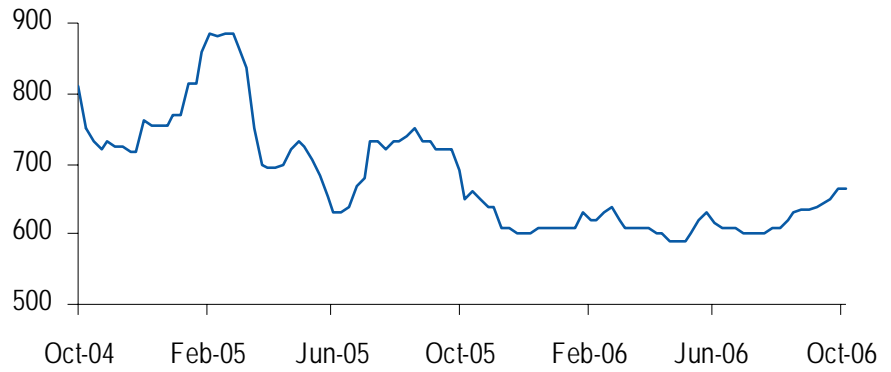


Source: Company reports.

China's spot iron ore prices fell in 2006 due to rising production in China. In the first eight months, China's fixed asset investment in non-ferrous mining sectors rose by 56% Y/Y, following the massive 115-166% in 2004 and 2005. The large increase of fixed asset investment is a leading indicator that shows iron ore production growth in China might remain strong in 2007.

Figure 8: China—Iron ore spot prices

Rmb/t



Source: www.mysteel.com.

Table 11: Fixed asset investment in mining and smelting of ferrous metal

Rmb in millions

	Mining (iron ore, etc)	Y/Y	Steel making	Y/Y
2004	13,294	166%	178,028	27%
2005	28,200	115%	228,149	28%
Jan-Aug 05	14,659	99%	134,584	21%
Jan-Aug 06	22,922	56%	132,750	-1%

Source: CEIC.

Figure 9: China Oriental—Summary of financials

Profit and loss statement						Cash flow statement					
CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E	CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E
Revenues	9,119	9,183	10,817	11,764	11,973	EBIT	1,229	1,081	1,223	1,545	1,991
% change Y/Y	72.8	0.7	17.8	8.8	1.8	Depreciation & amortization	150	297	333	363	393
Gross margin (%)	14.4	13.3	12.5	15.6	19.1	Change in working capital	-469	269	-381	-38	12
EBITDA	1,378	1,378	1,556	1,908	2,383	Taxes	30	-157	-171	-219	-286
% change Y/Y	9.1	0.0	12.9	22.6	24.9	Cash flow from operations	393	620	928	1,549	1,980
EBITDA margin (%)	15.1	15.0	14.4	16.2	19.9	Capex	-1257	-900	-2728	-6317	-6317
EBIT	1,229	1,081	1,223	1,545	1,991	Disposal/ (purchase)	0	0	0	0	0
% change Y/Y	5.3	-12.0	13.1	26.3	28.8	Net interest	-64	-74	-82	-82	-82
EBIT margin (%)	13.5	11.8	11.3	13.1	16.6	Free cash flow	533	758	2659	3293	6359
Net interest	-64	-74	-82	-82	-82	Equity raised/ (repaid)	2,107	0	0	0	0
Earnings before tax	1,171	1,005	1,139	1,462	1,907	Debt raised/ (repaid)	-500	-249	0	0	0
% change Y/Y	2.5	-14.2	13.4	28.3	30.5	Other	186	-585	0	0	0
Tax	30	157	171	219	286	Dividends paid	-625	-136	-195	-245	-245
as % of EBT	2.6	-15.6	-15.0	-15.0	-15.0	Beginning cash	153	2,925	1,725	1,858	2,662
Net income (reported)	1,173	847	977	1,224	1,576	Ending cash	2,925	1,725	1,858	2,662	3,897
% change Y/Y	9.0	-27.8	15.3	25.3	28.8	DPS (CNY)	0.226	0.047	0.067	0.084	0.108
Shares outstanding (MM)	2770	2905	2905	2905	2905						
EPS (reported) (CNY)	0.424	0.292	0.336	0.421	0.542						
% change Y/Y	-17.4	-31.2	15.3	25.3	28.8						

Balance sheet						Ratio analysis					
CNY in millions, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E	%, year-end Dec	FY04E	FY05E	FY06E	FY07E	FY08E
Cash and cash equivalents	2,925	1,725	1,858	2,662	3,897	EBITDA margin	15.1	15.0	14.4	16.2	19.9
Accounts receivable	828	714	841	915	931	Operating margin	13.5	11.8	11.3	13.1	16.6
Inventories	900	1,103	1,312	1,376	1,343	Net profit margin	12.9	9.2	9.0	10.4	13.2
Others	412	253	298	324	329	SG&A/sales	15.1	15.0	14.4	16.2	19.9
Current assets	5,065	3,796	4,308	5,276	6,501	Sales per share growth	72.8	0.7	17.8	8.8	1.8
Long-term investments	0	0	0	0	0	Sales growth	72.8	0.7	17.8	8.8	1.8
Net fixed assets	2,349	4,236	4,504	4,641	4,748	Net profit growth	9.0	-27.8	15.3	25.3	28.8
Total assets	7,482	8,153	9,197	10,327	11,639	EPS growth	-17.4	-31.2	15.3	25.3	28.8
Liabilities						Interest coverage (x)	21.4	18.6	19.1	23.4	29.2
Short-term loans	1,420	1,336	1,336	1,336	1,336	Net debt to total capital	-14.2	-1.2	-2.5	-10.1	-19.7
Payables						Net debt to equity	-26.9	-2.1	-4.2	-16.2	-29.6
Others	1,577	1,929	1,911	2,030	2,033	Sales/assets	173.0	117.5	124.7	120.5	109.0
Total current liabilities	2997	3112	3398	3530	3536	Assets/equity	192.6	177.5	171.4	162.3	151.7
Long-term debt	459	294	294	294	294	ROE	48.6	20.0	19.6	20.9	22.5
Other liabilities	25	15	0	0	0	ROCE	31.9	18.0	18.5	20.6	23.0
Total liabilities	3481	3421	3692	3824	3831						
Shareholders' equity	3885	4593	5367	6364	7670						
BVPS (CNY)	1.403	1.581	1.847	2.191	2.640						

Source: Company, JPMorgan estimates.

Other Companies Recommended in This Report (all prices in this report as of market close on 02 November 2006)

Angang steel company limited - H (0347.HK/HK\$8.37/Neutral), Baoshan Iron & Steel - A (600019.SS/Rmb5.26/Overweight), China Oriental (0581.HK/HK\$1.73/Overweight), Maanshan Iron and Steel - H (0323.HK/HK\$3.15/Overweight)

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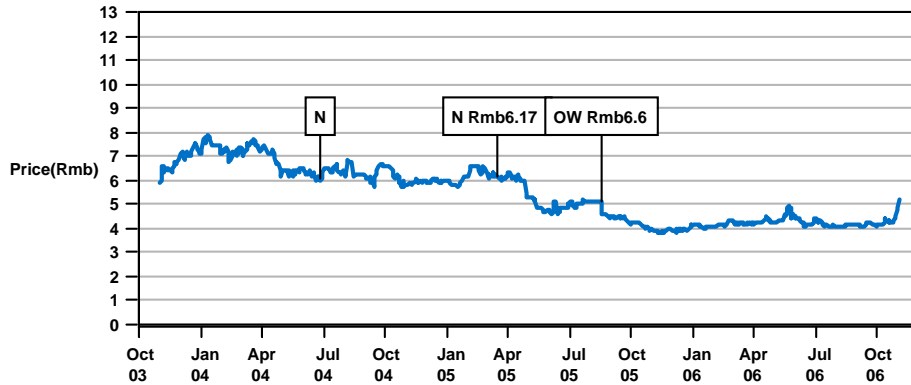
Angang steel company limited - H (0347.HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
06-Apr-04	N	4.50	-
07-Jan-05	OW	3.88	-
04-Jun-05	N	3.72	-
06-Mar-06	OW	6.30	7.70
17-Aug-06	N	6.60	7.50

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
 Break in coverage May 11, 2004 - Jan 07, 2005. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
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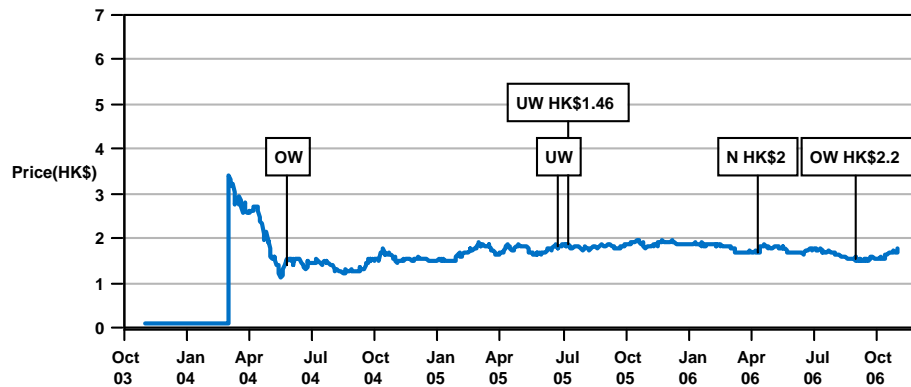
Baoshan Iron & Steel - A (600019.SS) Price Chart



Date	Rating	Share Price (Rmb)	Price Target (Rmb)
25-Jun-04	N	6.10	-
17-Aug-05	OW	5.14	6.60

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
 Initiated coverage Jun 25, 2004. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
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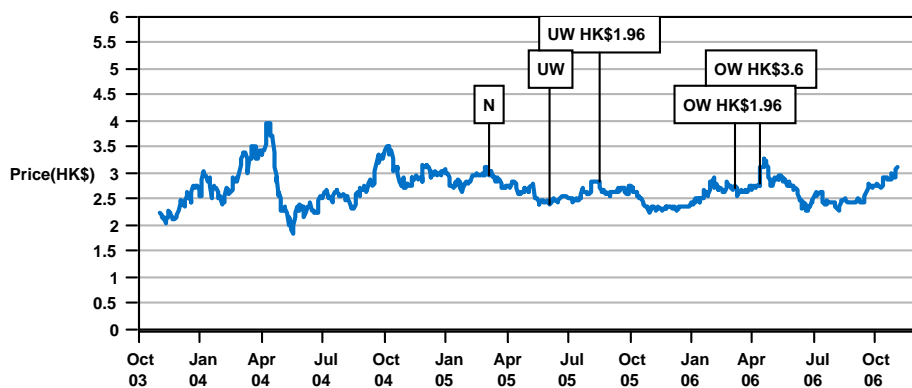
China Oriental (0581.HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
24-May-04	OW	1.39	-
23-Jun-05	UW	1.82	-
10-Apr-06	N	1.70	2.00
30-Aug-06	OW	1.52	2.20

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
 Initiated coverage May 24, 2004. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
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Maanshan Iron and Steel - H (0323.HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
05-Mar-05	N	2.95	-
04-Jun-05	UW	2.40	-
06-Mar-06	OW	2.72	1.96

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 05, 2005. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
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