

China Oriental

Attractive valuations

- **Maintain OW:** We reiterate our OW rating on China Oriental on attractive valuations. China Oriental is trading at 3.6x 2008E P/E compared to the 7.4x average P/E for larger listed steel makers, such as Maanshan and Baosteel. The valuation gap is too large to ignore. Our revised price target represents about a 37% upside.
- **Investment drivers:** We expect strong earnings growth in 2007E (up by 26%) and 2008E (up by 18%) on improving product mix and higher steel prices. We are positive on China steel prices on improving supply and demand situations and upcoming industry consolidation. (Please refer to our note, "Fundamentals still strong" dated 16 January 2007).
- **Catalysts, share price drivers:** The attractive valuation will likely drive up the stock price, in our view. China Oriental is trading at a 46% and a 53% discount, respectively, to Maanshan (0323.HK, OW) and Baosteel, based on 2008E P/B, but its 2008E ROE (22%) is very comparable to both Maanshan (20%) and to Baosteel(22%). The company will be in a positive free cash flow situation in 2006 and remain so in 2007 and 2008.
- **Price target, valuation, key risks:** We derive our Dec-07 price target of HK\$2.69 by applying 1x P/B to 2008E BVPS, with a 2008E ROE of 22%. A major risk is lower-than-expected steel and higher-than-expected raw material prices.

Reuters: 0581.HK; Bloomberg: 581 HK

Rmb in millions, year-end December

	2002	2003	2004E	2005E	2006E	2007E	2008E	52-week range	1.49-1.97
Sales	2,571	5,278	9,119	9,183	10,943	12,198	12,423	Market cap (HK\$MM)	5,723
Net profit	388	1,076	1,173	847	1,057	1,326	1,570	Market cap (US\$MM)	734
EPS (Rmb)	0.18	0.51	0.42	0.29	0.36	0.46	0.54	Free float (%)	28
EPS (% Y/Y)	152	177	-17	-31	25	26		Average daily volume (MM)	1.1
BPS (Rmb)	0.16	0.45	1.40	1.58	1.87	2.24	2.69	Shares outstanding (MM)	2,905
DPS (Rmb)	0.18	0.23	0.23	0.05	0.07	0.09	0.11	MSCI China	52
P/E	11.1	4.0	4.8	6.9	5.4	4.3	3.6	HK\$/US\$1	7.79
P/B	12.7	4.6	1.5	1.3	1.1	0.9	0.7		
EV/EBITDA	6.7	4.1	3.6	4.2	3.3	2.3	1.4		
Div yield (%)	9	11	11	2	4	5	5		
ROE (%)	115	168	49	20	21	22	22		
Net dbt/eqty (%)	69	90	-27	-2	-5	-18	-30		
Performance					1mth	3mths	12 mths		
Absolute (%)					10.1	20.9	7.1		
Relative to MSCI China(%)						0.6	-8.0		

Source: Datastream, Company data, JPMorgan estimates.

Overweight

HK\$1.97

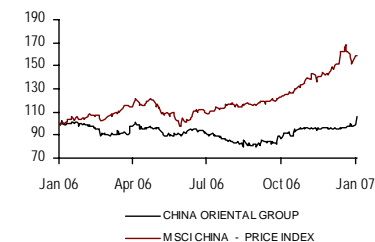
17 January 2007
Price Target: HK\$2.69

Hong Kong Steel

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One-year relative price performance %



Source: Datastream.

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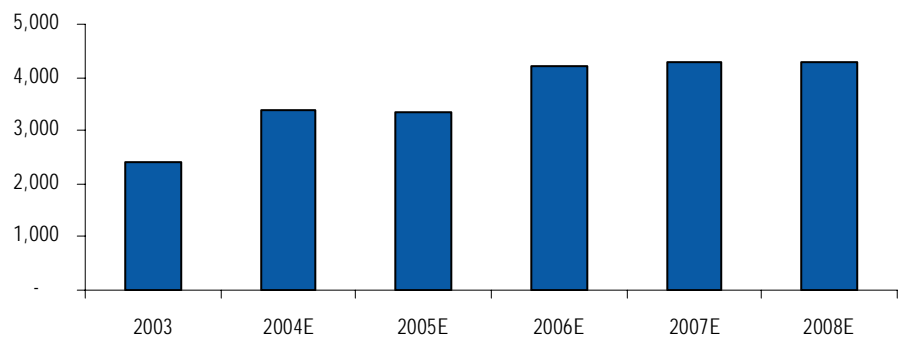
Company description

China Oriental, a medium-sized steel maker, is located in Northern China's Hebei province. Its major products are strips and H beam. Strips are used widely in various industries and H beam is mainly used in construction, steel structures, buildings, etc.

Volume sales are likely to grow by 26% in 2006. After that, volume sales might remain flat as the government restricts capacity expansion.

Figure 1: China Oriental Group—Volume sales

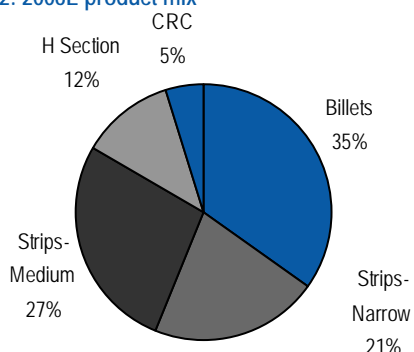
in '000 tons



Source: Company data, JPMorgan estimates.

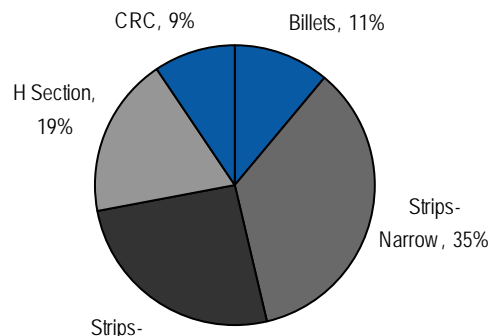
The company will strengthen its position by improving its product mix. The company will further reduce the sales of billets, a semi-finished steel product, and increase volume sales of value-added products, like H beam.

Figure 2: 2006E product mix



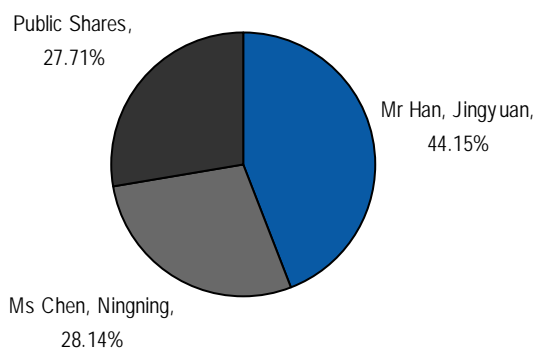
Source: JPMorgan estimates.

Figure 3: 2008E product mix



Source: JPMorgan estimates.

Figure 4: Shareholders' structure



Source: company

Earnings prospects

After two years of a decline, the company's earnings will likely resume growing by 26% in 2007 and 18% in 2008. The earnings decline in 2004 and 2005 was mainly due to rising iron ore prices and falling steel prices. We expect an earnings recovery in the next two years on higher steel price estimates and stable iron ore prices.

Table 1: China Oriental—Major assumptions

	2003	2004	2005	2006E	2007E	2008E
ASP (Rmb/t)	2,180	2,694	2,753	2,600	2,850	2,903
CRC (Rmb/t)			3,826	3,510	3,820	3,900
Volume sales ('000 tons)	2,421	3,385	3,336	4,210	4,280	4,280
COGS (Rmb/t)	1,671	2,307	2,386	2,255	2,419	2,397
Iron ore (Rmb/t)	418	710	735	629	665	619
Coking coal (Rmb/t)	809	1,055	1,107	969	1,025	1,025

Source: Company, JPMorgan estimates.

China's fixed asset investment in ferrous smelting (mainly steel) was flat, while fixed asset investment in mining (mainly iron ore) was up by 37% in the first eleven

months of 2006. The strong investment in iron ore capacity means supply should grow strongly in 2007 and 2008. Thus, we expect the iron ore price to go up slightly in 2007 and go down slightly in 2008 for China Oriental.

Table 2: Fixed asset investment in mining and smelting of ferrous metal

Rmb in millions

	Ferrous mining	Change (%)	Ferrous smelting	Change (%)
2004	13,294		178,028	
2005	28,200	112	228,149	28
Jan-Nov '05	22,864		194,873	
Jan-Nov '06	31,269	37	195,135	0

Source: CEIC.

Balance sheet check

The company's balance sheet is healthy with net cash position. In its 1H06 report, the cash was about Rmb242 million. But, there is Rmb1.3 billion in note receivables, which are all bank acceptance notes. And, in China, the risk of default on bank acceptance notes is very low. So, we consider the note receivables cash items in our forecasts.

The company will turn to a positive free cash flow position in 2006, and remain so in 2007 and 2008.

Table 3: China Oriental—Balance sheet and cash flow check

	2003	2004	2005	2006E	2007E	2008E
Operating cash flow	290	393	620	1,004	1,625	1,966
Capex	-429	-401	-850	-600	-500	-500
Free cash flow	-138	-57	-230	404	1,125	1,466
Net debt/equity (%)	90	-27	-2	-5	-18	-30

Source: Company data, JPMorgan estimates.

Attractive valuation

We raise our price target by 22% to HK\$2.69/share from HK\$2.2/share as we switch from using 1x 2007E P/B to 2x 2008E P/B.

The company is trading at a huge discount to its larger counterparts, such as Maanshan (40%) and Baosteel (50%) on 2008E P/B multiple, although China Oriental's 2008E ROE (22%) is very comparable to Maanshan (20%) and Baosteel (22%).

Table 4: Valuation comparison

	China Oriental (581 HK)			Maanshan (323 HK)			Baosteel (600019 CH)			Angang (347 HK)		
	2006E	2007E	2008E	2006E	2007E	2008E	2006E	2007E	2008E	2006E	2007E	2008E
P/E (x)	5.4	4.3	3.6	14.6	10.2	7.1	13.4	10.5	7.4	10.6	9.0	7.8
P/B (x)	1.1	0.9	0.7	1.6	1.5	1.3	2.0	1.8	1.5	2.6	2.2	2.0
EV/EBITDA (x)	3.3	2.3	1.4	8.1	6.3	3.8	6.4	5.0	3.8	6.1	5.7	5.2
ROE (%)	21	22	22	11	16	20	16	18	22	34	26	27

Source: JPMorgan estimates. Note: Priced as of 17 January 2007.

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Angang Steel Company Limited - H (0347.HK/HK\$11.76/Neutral), Baoshan Iron & Steel - A (600019.SS/Rmb9.34/Overweight), Maanshan Iron and Steel - H (0323.HK/HK\$4.71/Overweight)

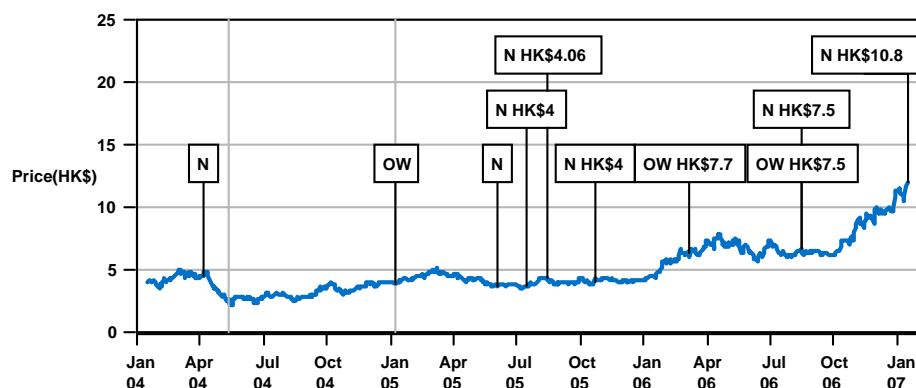
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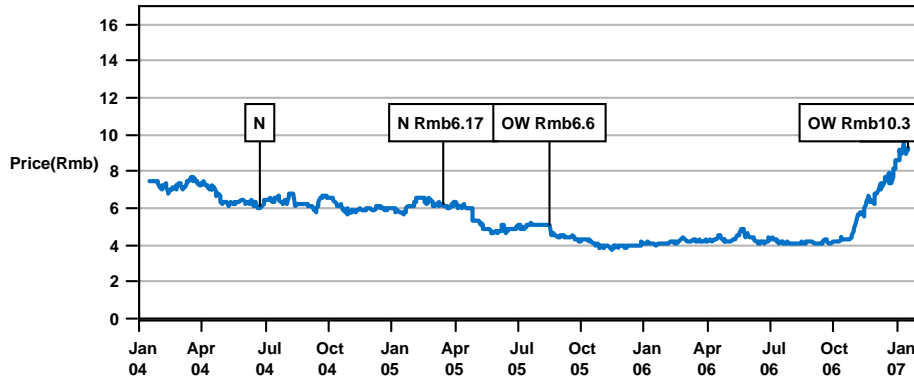
Angang Steel Company Limited - H (0347.HK) Price Chart



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.
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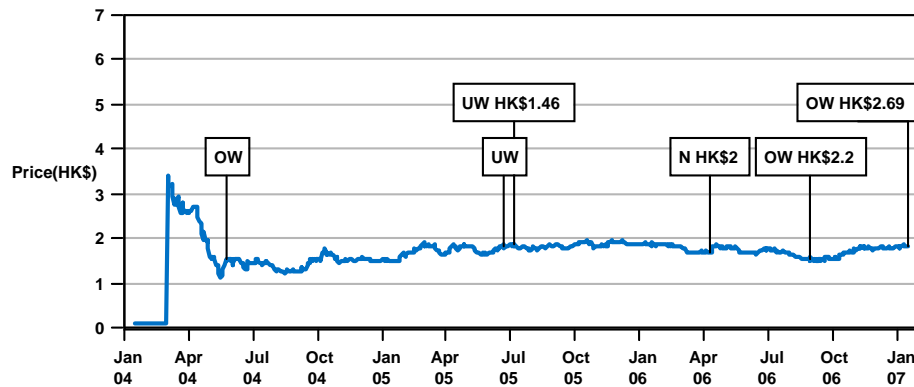
Baoshan Iron & Steel - A (600019.SS) Price Chart



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.
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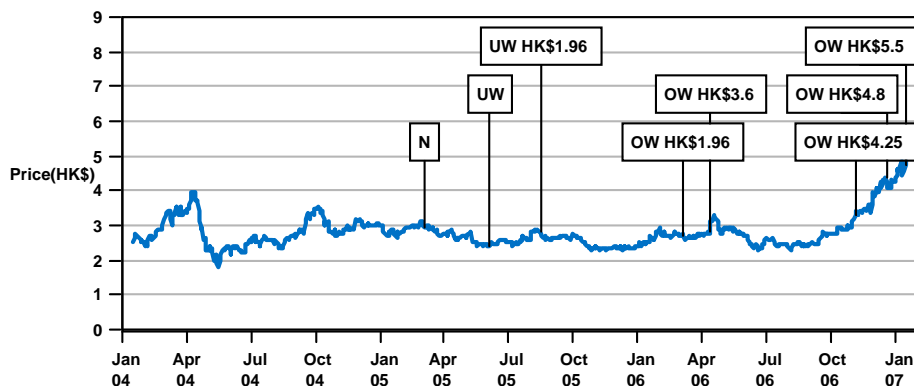
China Oriental (0581.HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
24-May-04	OW	1.53	-
23-Jun-05	UW	1.82	-
10-Apr-06	N	1.68	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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Revised December 29, 2006.

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China Oriental: Summary of financials

Profit and Loss statement						Cash flow statement					
CNY in millions, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E	CNY in millions, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E
Revenues	9,119	9,183	10,943	12,198	12,423	EBIT	1,229	1,081	1,315	1,663	1,980
% change Y/Y	72.8	0.7	19.2	11.5	1.8	Depreciation & amortisation	150	297	333	363	393
Gross Margin (%)	14.4	13.3	13.2	15.1	17.4	Change in working capital	-469	269	-385	-64	3
EBITDA	1,378	1,378	1,647	2,026	2,373	Taxes	30	-157	-185	-237	-284
% change Y/Y	9.1	0.0	19.6	23.0	17.1	Cash flow from operations	393	620	1,004	1,625	1,966
EBITDA Margin (%)	15.1	15.0	15.1	16.6	19.1	Capex	-401	-850	-600	-500	-500
EBIT	1,229	1,081	1,315	1,663	1,980	Disposal/ (purchase)	0	0	0	0	0
% change Y/Y	5.3	-12.0	21.6	26.5	19.1	Net Interest	-64	-74	-82	-82	-82
EBIT Margin (%)	13.5	11.8	12.0	13.6	15.9	Free cash flow	-8	-230	404	1,125	1,466
Net Interest	-64	-74	-82	-82	-82	Equity raised/ (repaid)	2,107	0	0	0	0
Earnings before tax	1,171	1,005	1,231	1,579	1,896	Debt raised/ (repaid)	-500	-249	0	0	0
% change Y/Y	2.5	-14.2	22.5	28.3	20.1	Other	186	-585	0	0	0
Tax	30	157	185	237	284	Dividends paid	-625	-136	-211	-265	-265
as % of EBT	2.6	-15.6	-15.0	-15.0	-15.0	Beginning cash	153	2,925	1,725	1,918	2,778
Net Income (Reported)	1,173	847	1,057	1,326	1,570	Ending cash	2,925	1,725	1,918	2,778	3,978
% change Y/Y	9.0	-27.8	24.7	25.5	18.4	DPS	0.226	0.047	0.073	0.091	0.108
Shares Outstanding	2770	2905	2905	2905	2905						
EPS (reported)	0.424	0.292	0.364	0.457	0.540						
% change Y/Y	-17.4	-31.2	24.7	25.5	18.4						
Balance sheet						Ratio Analysis					
CNY in millions, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E	%, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E
Cash and cash equivalents	2,925	1,725	1,918	2,778	3,978	EBITDA margin	15.1	15.0	15.1	16.6	19.1
Accounts receivable	828	714	851	949	966	Operating margin	13.5	11.8	12.0	13.6	15.9
Inventories	900	1,103	1,316	1,435	1,422	Net profit margin	12.9	9.2	9.7	10.9	12.6
Others	412	253	301	336	342	SG&A/sales	15.1	15.0	15.1	16.6	19.1
Current assets	5,065	3,796	4,387	5,497	6,708	Sales per share growth	72.8	0.7	19.2	11.5	1.8
LT investments	0	0	0	0	0	Sales growth	72.8	0.7	19.2	11.5	1.8
Net fixed assets	2,349	4,236	4,504	4,641	4,748	Net profit growth	9.0	-27.8	24.7	25.5	18.4
Total assets	7,482	8,153	9,274	10,544	11,861	EPS growth	-17.4	-31.2	24.7	25.5	18.4
Liabilities						Interest coverage (x)	21.4		20.2	24.9	29.1
ST loans	1,420	1,336	1,336	1,336	1,336	Net debt to total capital	-14.2	-1.2	-3.2	-11.0	-20.0
Payables						Net debt to equity	-26.9	-2.1	-5.3	-17.6	-30.1
Others	1,577	1,929	1,924	2,099	2,115	Sales/assets	173.0	117.5	125.6	123.1	110.9
Total current liabilities	2,997	3,112	3,412	3,605	3,624	Assets/equity	192.6	177.5	170.8	162.1	152.0
Long term debt	459	294	294	294	294	ROE	48.6	20.0	21.1	22.2	21.9
Other liabilities	25	15	0	0	0	ROCE	31.9	18.0	19.8	21.9	22.5
Total liabilities	3,481	3,421	3,707	3,899	3,919						
Shareholders' equity	3,885	4,593	5,429	6,506	7,804						
BVPS	1.403	1.581	1.869	2.239	2.686						

Source: Company, JPMorgan estimates.