

Shares undervalued plus organic growth

Equity | China | Steels
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Merrill Lynch

Alexander Latzer >>

+852 2536 3453

Research Analyst
Merrill Lynch (Hong Kong)
a_latzer@ml.com

Desiree Dang, CFA >>>

Research Analyst
desiree_dang@ml.com

Reiterate Buy rating with PO raised to HK\$3.20

Most China steel stocks are trading at or above fair value after more than doubling since Oct. '06. We recommend investors become more selective and focus on value/organic growth. China Oriental is our top pick with valuation very attractive at 4.5x '08E PER – a 40% discount to peers. We are raising our PO from HK\$1.85 to HK\$3.20, based on 6.4x 08E PER and NPV of HK\$3.20.

Fundamentals improving with richer product mix

Historically a low end steel producer, China Oriental is lifting its product mix by introducing value added H-beam and CRC production. It will also benefit from healthy industry growth and is protected from an export slowdown with exports nil. We believe it is unjustified to exclude China Oriental from recent sector re-rating.

Estimates up on higher steel price assumption

We have slightly lowered our 2006 EPS estimates by 2.8% to reflect the iron ore price strength in the domestic market during 4Q06, but have raised our 2007 and 2008 estimates by 8.6% and 35% respectively, due to our higher steel price assumption. Our current EPS forecast for 2006-2008 are Rmb0.39, Rmb0.44 and Rmb0.50 respectively, representing 13% and 15% growth the next two years.

Steel market remains balanced but upside limited

We maintain our view that Chinese steel demand/supply remains balanced, but with the risk that exports slow due to further VAT rebate cuts, a global demand slowdown, and a narrower price gap between China and overseas markets. We forecast prices for flat steel increasing 7% YoY in 2007 and 2% YoY in 2008.

For further details please see "China steel sector: downgrade from overweight to selective" dated February 16, 2007.

Estimates (Dec)

(CNY)	2004A	2005A	2006E	2007E	2008E
Net Income (Adjusted - mn)	1,181	847	1,120	1,267	1,460
EPS	0.426	0.291	0.385	0.436	0.502
EPS Change (YoY)	-16.8%	-31.7%	32.3%	13.1%	15.2%
Dividend / Share	0.215	0.047	0.062	0.065	0.075
Free Cash Flow / Share	(0.018)	(0.246)	0.181	0.249	0.368

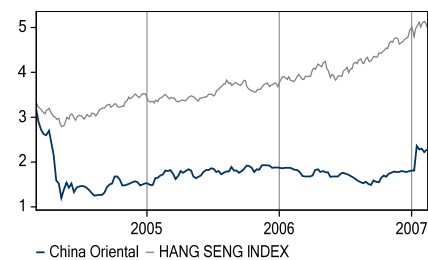
Valuation (Dec)

	2004A	2005A	2006E	2007E	2008E
P/E	6.26x	9.16x	6.93x	6.13x	5.32x
Dividend Yield	8.06%	1.75%	2.32%	2.45%	2.82%
EV / EBITDA*	6.77x	6.99x	5.52x	4.85x	4.07x
Free Cash Flow Yield*	-0.652%	-9.21%	6.78%	9.31%	13.78%

* For full definitions of *iQmethod*SM measures, see page 5.

Stock Data

Price	HK\$2.69
Price Objective	HK\$1.85 to HK\$3.20
Date Established	16-Feb-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	HK\$1.47-HK\$2.79
Mrkt Val / Shares Out (mn)	US\$1,000 / 2,905.0
Average Daily Volume	6,413,361
ML Symbol / Exchange	CUGCF / HKG
Bloomberg / Reuters	581 HK / 0581.HK
ROE (2006E)	22.1%
Net Dbt to Eqty (Dec-2005A)	19.4%
Est. 5-Yr EPS / DPS Growth	19.9% / 19.9%
Free Float	24.2%



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Refer to important disclosures on page 6 to 7. Analyst Certification on page 5. Price Objective Basis/Risk on page 5.

16 February 2007

*iQprofile*SM China Oriental Group Company, Inc.

Key Income Statement Data (Dec)	2004A	2005A	2006E	2007E	2008E
(CNY Millions)					
Sales	9,119	9,182	10,578	12,046	13,111
Gross Profit	1,311	1,223	1,556	1,758	1,996
Sell General & Admin Expense	(155)	(159)	(206)	(235)	(256)
Operating Profit	1,156	1,064	1,350	1,523	1,740
Net Interest & Other Income	20	(60)	(13)	(18)	10
Associates	NA	NA	NA	NA	NA
Pretax Income	1,176	1,004	1,337	1,505	1,750
Tax (expense) / Benefit	34	(157)	(206)	(232)	(270)
Net Income (Adjusted)	1,181	847	1,120	1,267	1,460
Average Fully Diluted Shares Outstanding	2,770	2,905	2,905	2,905	2,905

Key Cash Flow Statement Data

Net Income (Reported)	1,181	847	1,120	1,267	1,460
Depreciation & Amortization	150	199	250	297	431
Change in Working Capital	0	268	(57)	(48)	(42)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(980)	3	13	6	20
Cash Flow from Operations	351	1,316	1,326	1,522	1,869
Capital Expenditure	(401)	(2,031)	(800)	(800)	(800)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	(49)	(101)	(2)	0	0
Cash Flow from Investing	(450)	(2,132)	(802)	(800)	(800)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	0	(136)	(180)	(190)	(219)
Cash Flow from Financing	0	307	(180)	(190)	(219)
Free Cash Flow	(51)	(715)	526	722	1,069
Net Debt	661	920	577	44	(806)
Change in Net Debt	102	259	(344)	(532)	(850)

Key Balance Sheet Data

Property, Plant & Equipment	2,404	4,236	4,786	5,289	5,658
Other Non-Current Assets	12	121	121	121	121
Trade Receivables	828	714	823	937	1,020
Cash & Equivalents	1,218	710	1,054	1,586	2,436
Other Current Assets	3,019	2,372	2,557	2,773	2,917
Total Assets	7,482	8,153	9,341	10,706	12,152
Long-Term Debt	459	294	294	294	294
Other Non-Current Liabilities	25	15	15	15	15
Short-Term Debt	1,420	1,336	1,336	1,336	1,336
Other Current Liabilities	1,577	1,776	2,013	2,295	2,480
Total Liabilities	3,481	3,421	3,658	3,940	4,125
Total Equity	4,001	4,732	5,683	6,766	8,027
Total Equity & Liabilities	7,482	8,153	9,341	10,706	12,152

*iQmethod*SM - Bus Performance*

Return On Capital Employed	26.6%	15.5%	17.0%	17.0%	17.1%
Return On Equity	48.9%	20.0%	22.1%	20.9%	20.2%
Operating Margin	12.7%	11.6%	12.8%	12.6%	13.3%
EBITDA Margin	14.3%	13.8%	15.1%	15.1%	16.6%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	0.3x	1.6x	1.2x	1.2x	1.3x
Asset Replacement Ratio	2.7x	10.2x	3.2x	2.7x	1.9x
Tax Rate (Reported)	NM	15.6%	15.4%	15.4%	15.4%
Net Debt-to-Equity Ratio	16.5%	19.4%	10.1%	0.7%	-10.0%
Interest Cover	18.0x	14.3x	22.6x	20.8x	23.7x

Key Metrics

* For full definitions of *iQmethod*SM measures, see page 5.

Company Description

China Oriental Group Co. Ltd. (COGCL) was incorporated in Nov. 2003 and listed on the Hong Kong stock market in March 2004. Its major operating asset is its 97.6% interest in Hebei Jinxi Iron & Steel Co., Ltd (Jinxi Steel), which is the 7th-largest integrated steel maker in northern China. It was ranked No. 24 in China in terms of steel output in 2003. COGCL's 2 major products are steel billets & hot-rolled strips (68% & 31% of total revenues, re

Stock Data

Price to Book Value 1.4x

Financial Statement

Table 1: Profit & Loss (mn Rmb)

	2004A	2005A	2006E	2007E	2008E
Revenue	9,119	9,182	10,578	12,046	13,111
<i>YoY Chg</i>	<i>73%</i>	<i>1%</i>	<i>15%</i>	<i>14%</i>	<i>9%</i>
Billets	5,215	3,632	3,285	2,417	0
Strips	3,871	5,389	5,692	6,091	0
CRC JV-60% equities	0	117	373	1,006	0
H-beam	0	0	1,184	2,488	0
Others	33	45	44	45	13,111
COGS	-7,808	-7,959	-9,022	-10,288	-11,115
Gross Profit	1,311	1,223	1,556	1,758	1,996
<i>Gross margin</i>	<i>14%</i>	<i>13%</i>	<i>15%</i>	<i>15%</i>	<i>15%</i>
SG&A	-155	-159	-206	-235	-256
EBITDA	1,156	1,263	1,600	1,820	2,172
<i>EBITDA margin</i>	<i>13%</i>	<i>14%</i>	<i>15%</i>	<i>15%</i>	<i>17%</i>
EBIT	1,156	1,064	1,350	1,523	1,740
<i>EBIT margin</i>	<i>13%</i>	<i>12%</i>	<i>13%</i>	<i>13%</i>	<i>13%</i>
Net financing cost	-31	-8	-32	-18	9
Others	52	-52	20	0	0
PBT	1,176	1,004	1,337	1,505	1,750
Tax	34	-157	-206	-232	-270
<i>Effective Tax rate</i>	<i>-3%</i>	<i>16%</i>	<i>15%</i>	<i>15%</i>	<i>15%</i>
Profit attribute to minorities	-29	-1	-11	-6	-21
Reported NPAT	1,181	847	1,120	1,267	1,459
<i>NPAT Growth</i>	<i>10%</i>	<i>-28%</i>	<i>32%</i>	<i>13%</i>	<i>15%</i>
<i>Net margin</i>	<i>13%</i>	<i>9%</i>	<i>11%</i>	<i>11%</i>	<i>11%</i>
Reported EPS (Rmb\$)	0.43	0.29	0.39	0.44	0.50
Adjusted EPS (Rmb\$)	0.41	0.29	0.39	0.44	0.50
P/E (x)	3.8	5.3	4.0	3.6	3.1
DPS (Rmb\$)	0.22	0.05	0.06	0.07	0.08
Yield (%)	13.9	3.0	4.0	4.2	4.9
Interest coverage (x)	36.9	135.3	41.9	83.9	-184.0
Payout ratio	50%	16%	16%	15%	15%

Source: Merrill Lynch estimates, Company data

Table 2: Balance Sheet (mn Rmb)

	2004A	2005E	2006E	2007E	2008E
Cash and cash equivalents	1,218	710	1,054	1,586	2,436
Restricted bank balance	1,708	1,015	1,015	1,015	1,015
Accounts receivable	828	714	823	937	1,020
Inventories	900	1,103	1,251	1,426	1,541
Other current assets	411	253	291	332	361
Current Assets	5,065	3,796	4,434	5,296	6,373
Fixed Assets	2,404	4,236	4,786	5,289	5,658
Other long-term assets	12	121	121	121	121
Non-current Assets	2,417	4,357	4,907	5,410	5,779
Total Assets	7,482	8,153	9,341	10,706	12,152
Short-term debt	1,420	1,336	1,336	1,336	1,336
Accounts payables	418	632	717	818	883
Other current Liabilities	1,159	1,143	1,296	1,478	1,597
Current Liabilities	2,997	3,112	3,349	3,631	3,816
Long-term Debt	459	294	294	294	294
Deferred tax, others	25	15	15	15	15
Total Liabilities	3,481	3,421	3,658	3,940	4,125
Minorities interest	116	139	150	156	177
Equities=Net Assets	3,885	4,593	5,533	6,610	7,850
Book Value per share	1.40	1.58	1.90	2.28	2.70
Net Debt/(Net Cash)	661	920	577	44	-806
Net Debt/Equity	17%	20%	10%	1%	-10%

Table 2: Balance Sheet (mn Rmb)

	2004A	2005E	2006E	2007E	2008E
ROAA	20.8	10.8	12.8	13.5	13.6
ROAE	48.9	20.0	22.1	22.7	21.9
Inventory days (days)	37	46	48	47	49
Acc receivable days (days)	22	31	27	27	27
Acc payable days (days)	17	24	27	27	28
Share at Year end	2,905	2,905	2,905	2,905	2,905

Source: Merrill Lynch estimates, Company data

Table 3: Cash flow (mn Rmb)

	2004A	2005A	2006E	2007E	2008E
PBT	0	1,004	1,337	1,505	1,750
D&A	0	199	250	297	431
Changes in WC	0	268	-57	-48	-42
Other adjustments	351	-155	-204	-232	-270
Operating cash flow	351	1,316	1,326	1,522	1,869
Capex	-401	-2,031	-800	-800	-800
Others	-49	-101	-2	0	0
Investing cash flow	-450	-2,132	-802	-800	-800
Dividends Paid	0	-136	-180	-190	-219
Increase in ST & LT Debt	0	-249	0	0	0
Increase in Capital Stocks	0	0	0	0	0
Other Financing Activities	1,168	693	0	0	0
Financing cash flow	1,168	307	-180	-190	-219
Increase in cash	1,068	-508	344	532	850
Free Cash Flow	-100	-816	524	722	1,069
CFPS (Rmb)	0.12	0.45	0.46	0.52	0.64
FCFPS (Rmb)	-0.03	-0.28	0.18	0.25	0.37

Source: Merrill Lynch estimates, Company data

Price Objective Basis & Risk

China Oriental: Our PO of HK\$3.2 is based on 6.4x 2008E PER and NPV valuation. The 6.4x PER is based on 20% discount to its peers average and also in line with its historical range. Our NPV valuation of HK\$3.21 is based on WACC of 10.5% and long term growth rate of 1.5%.

The risks to our recommendation are an unexpected production delay in its new production line or weaker than expected steel price.

Analyst Certification

We, Alexander Latzer and Desiree Dang, CFA, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

*iQmethod*SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

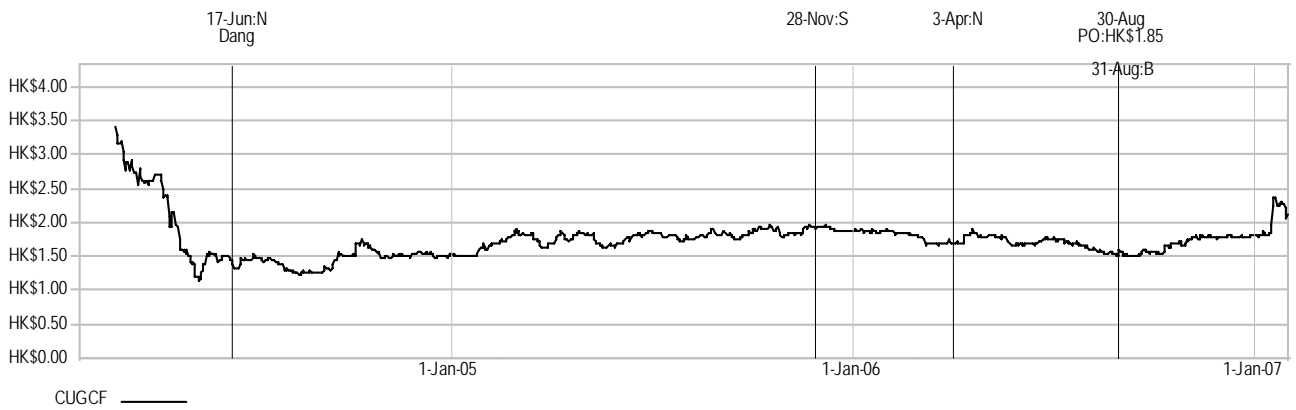
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CUGCF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of January 31, 2007 or such later date as indicated.

Investment Rating Distribution: Steel Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	17	54.84%	Buy	1	5.88%
Neutral	13	41.94%	Neutral	3	23.08%
Sell	1	3.23%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

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