

# EPS bit light; Growth program on track, reiterate Buy

Equity | China | Steels  
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## Merrill Lynch

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## 2006 EPS light vs. expectations; But gains impressive YoY

China Oriental Group (COGCL) reported lighter than expected 2006 EPS due to lower than forecast volumes and higher expenses. Earnings were Rmb0.36/sh in 2006, up 22% from Rmb0.29/sh in 2005, but below the ML est. of Rmb0.39/sh.

## Outlook unchanged on continued operating improvements

Gains were impressive YoY and COGCL's capital growth/mix improvement program is on track. We see nothing here to derail our view on the positive outlook for higher margins based on the expansion of H beam and CR capacity. If anything, the company indicated capacity additions could be further extended.

## Shares very inexpensive relative to the peer group

The stock remains cheap, trading at a 50% discount to the ML global steel universe at 5.0x 2008E EPS. Our P.O. of HK\$3.20/sh is based on 6.5x 2008E EPS of Rmb0.50 and is equal to our NPV valuation. Accordingly, we reiterate our Buy rating.

## Results benefited from product mix shift

The mix shift is coming at just the right time. Despite lower prices for billets and strips, margins improved due to new H beam production and further gains are expected when the CR capacity additions flow through to EPS this year.

Operating margins increased from 12% to 13% in 2006 and oper. profit per t 6.2% from Rmb319 (US\$41.16/t) to Rmb331 (US\$42.71/t). Net margin increased from 9% to 11%. Net margin would have improved further, but for higher SG&A exp.

## Steel industry fundamentals holding up well

Despite concerns about excess production and the adverse impact of the upcoming reduction in the VAT rebate, steel prices remain stable. We look for market prices (HRB) to increase 7% in '07 (US\$510/t) and 2% in '08 (US\$536/t).

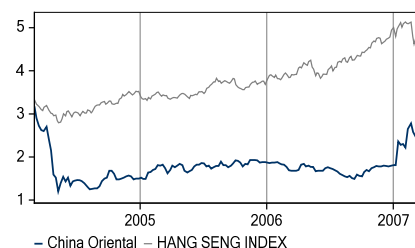
## Connected party takeover offer restrictions in effect

Due to the connected party takeover offer (Smart Triumph, 27% owner bidding for shares held by Wellbeing Holdings 45% share) management was not available for follow up discussions and the company did not host an analyst meeting.

We believe the timing is unfortunate as the need to communicate the progress of the value added growth program remains important. We are hopeful that the internal battle does not distract management from effectively implementing the program and maintaining good control of the business units.

## Stock Data

Price	HK\$2.51
Price Objective	HK\$3.20
Date Established	15-Feb-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
ML Symbol / Exchange	CUGCF / HKG
Bloomberg / Reuters	581 HK / 0581.HK



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Refer to important disclosures on page 5 to 6. Analyst Certification on page 3. Price Objective Basis/Risk on page 3.

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## Variance table 2006 results vs. 2005 and to ML estimates

**Table 1: Results comparison**

		<u>2005A</u>	<u>2006A</u>	<u>YoY</u>	<u>ML Est.</u> <u>2006</u>	<u>Variation</u> <u>vs. ML est.</u>	<u>2007E</u>	<u>YoY</u>	<u>2008E</u>	<u>YoY</u>
<b>Unit Sales Price:</b>										
Billets	Rmb/t	2,491	2,347	-6%	2,347	0%	2,417	3%	2,417	0%
Strips and strip products		2,917	2,600	-11%	2,548	2%	2,782	7%	2,838	2%
H-Sections		NA	2,917	NA	2,960	-1%	3,082	6%	3,138	2%
CRC		3,831	3,502	-9%	3,274	7%	3,864	10%	3,942	2%
Galvanized		<u>NA</u>	<u>4,932</u>	<u>NA</u>	<u>NA</u>	NA	<u>5,306</u>	<u>8%</u>	<u>5,412</u>	2%
<b>Average</b>		<b>2,739</b>	<b>2,601</b>	<b>-5%</b>	<b>2,558</b>	<b>2%</b>	<b>2,806</b>	<b>8%</b>	<b>2,901</b>	<b>3%</b>
<b>Sales Volumes:</b>										
Billets	'000 t	1,458	1,173	-20%	1,400	-16%	1,250	7%	1,000	-20%
Strips and strip products		1,848	2,202	19%	2,200	0%	2,200	0%	2,200	0%
H-Sections		<u>0</u>	<u>250</u>	<u>NA</u>	<u>400</u>	-38%	<u>550</u>	<u>120%</u>	<u>800</u>	45%
<b>Total steel products (except CRC &amp; Galvanized)</b>		<b>3,305</b>	<b>3,625</b>	<b>10%</b>	<b>4,000</b>	<b>-9%</b>	<b>4,000</b>	<b>10%</b>	<b>4,000</b>	<b>0%</b>
CRC		31	45	47%	100	-55%	80	79%	90	13%
Galvanized		0	77	NA	NA	NA	120	56%	135	13%
<b>Profit &amp; Loss</b>										
<b>Revenue</b>										
Billets	Rmb mn	3,632	2,753	-24%	3,285	-16%	3,022	10%	2,417	-20%
Strips		5,389	5,723	6%	5,692	1%	6,120	7%	6,243	2%
H-Sections		0	729	NA	1,184	-38%	1,695	133%	2,510	48%
CRC		117	160	37%	327	-51%	309	93%	355	15%
Galvanized		0	381	NA	NA	NA	637	67%	731	15%
Others		<u>45</u>	<u>36</u>	-20%	<u>95</u>	-62%	<u>36</u>	0%	<u>36</u>	0%
<b>Total Revenue</b>		<b>9,182</b>	<b>9,782</b>	<b>7%</b>	<b>10,583</b>	<b>-8%</b>	<b>11,969</b>	<b>22%</b>	<b>12,716</b>	<b>6%</b>
<b>Total COGS</b>		<b>-7,959</b>	<b>-8,358</b>	<b>5%</b>	<b>-9,023</b>	<b>-7%</b>	<b>-10,153</b>	<b>21%</b>	<b>-10,479</b>	<b>3%</b>
<b>Gross Operational Income</b>		<b>1,223</b>	<b>1,424</b>	<b>16%</b>	<b>1,561</b>	<b>-9%</b>	<b>1,816</b>	<b>28%</b>	<b>2,238</b>	<b>23%</b>
SG&A		<u>-159</u>	<u>-184</u>	15%	<u>-205</u>	-11%	<u>-224</u>	22%	<u>-233</u>	4%
<b>EBIT</b>		<b>1,064</b>	<b>1,241</b>	<b>17%</b>	<b>1,356</b>	<b>-8%</b>	<b>1,592</b>	<b>28%</b>	<b>2,004</b>	<b>26%</b>
Interest income		66	19	-71%	55	-66%	9	-53%	33	275%
Interest expense		-74	-50	-32%	-73	-31%	-37	-27%	-37	0%
Investment income		-2	0	-100%	-2	NA	-2	NA	-2	0%
Others		<u>-50</u>	<u>24</u>	-148%	<u>9</u>	163%	<u>0</u>	-100%	<u>0</u>	NA
<b>Profit Before Tax</b>		<b>1,004</b>	<b>1,233</b>	<b>23%</b>	<b>1,344</b>	<b>-8%</b>	<b>1,562</b>	<b>27%</b>	<b>1,999</b>	<b>28%</b>
Income Tax		<u>-157</u>	<u>-211</u>	34%	<u>-207</u>	2%	<u>-267</u>	27%	<u>-530</u>	98%
<b>Profit After Tax</b>		<b>847</b>	<b>1,022</b>	<b>21%</b>	<b>1,137</b>	<b>-10%</b>	<b>1,295</b>	<b>27%</b>	<b>1,469</b>	<b>13%</b>
Minorities		<u>-1</u>	<u>10</u>	NA	<u>-11</u>	NA	<u>-8</u>	NA	<u>-13</u>	71%
<b>Net Income</b>		<b>847</b>	<b>1,033</b>	<b>22%</b>	<b>1,126</b>	<b>-8%</b>	<b>1,287</b>	<b>25%</b>	<b>1,456</b>	<b>13%</b>
EPS	Rmb/sh	0.29	0.36	24%	0.39	-8%	0.44	25%	0.50	13%
DPS	Rmb/sh	0.05	0.06	19%	0.06	-11%	0.07	19%	0.08	13%

Source: Merrill Lynch estimates Company filings.

## Price Objective Basis & Risk

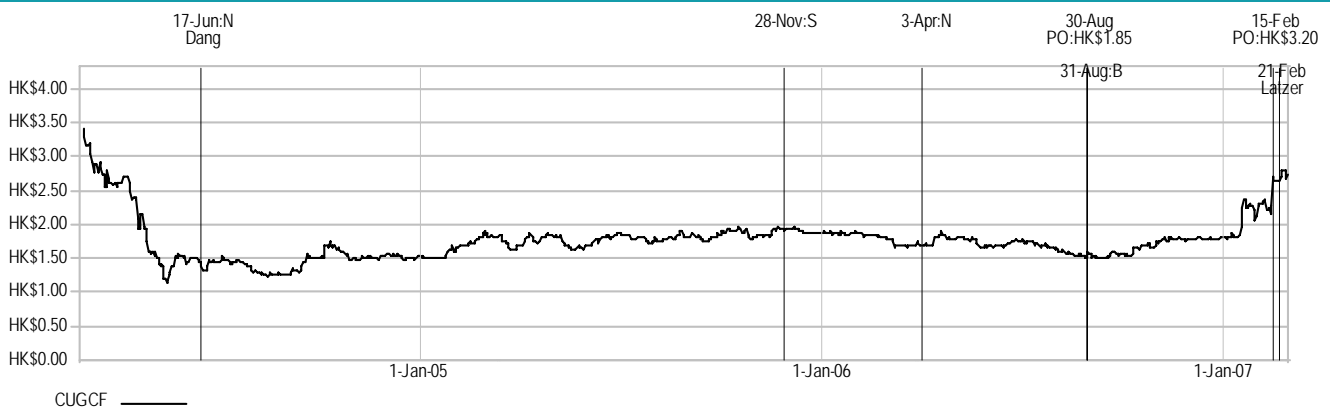
Our P.O. of HK\$3.20/sh is based on our NPV valuation and 6.5x 2008E EPS of Rmb0.50, which is more in line with the low end of the historical range. Risks to the shares achieving our objective include disruptions to operations and/or projects under development, higher than forecast raw materials costs and lower than forecast steel prices.

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	19	51.35%	Buy	1	6.25%
Neutral	17	45.95%	Neutral	3	20.00%
Sell	1	2.70%	Sell	0	0.00%

### Investment Rating Distribution: Global Group (as of 31 Mar 2007)

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Sell	282	8.15%	Sell	49	19.76%

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