

# China Oriental

FY06 result in line; we maintain OW

- **We remain OW:** China Oriental's 2006 EPS came in at Rmb0.36, slightly below our forecast of Rmb0.37, due to slightly lower-than-expected volume sales. We expect a further pick-up in steel prices in 2007 and 2008, and maintain our 2007 and 2008 earnings forecasts and our Overweight rating.
- **2007 EPS could grow by 35%Y/Y:** We expect EPS to grow by 35%Y/Y in 2007 and 17%Y/Y in 2008 on higher steel prices and better product mix (value-added H beam and strip to replace semi-finished product, billets). This should more than offset high raw material prices (iron ore and coke), and result in continued earnings growth in the next two years.
- **Talks on controlling stake continue:** The second-largest shareholder (28%) has been in talks with the largest shareholder for control of the firm. This might not yield any material result in the near future, however, and the cheap valuation of the stock is the primary reason for the fight over the controlling stake.
- **Valuations and risks to price target:** We derive our Dec-07 PT of HK\$3.3 by applying 1.2x P/BV to 2008E BVPS, with an ROE of 23%. China Oriental is trading at a deep discount (about 50%) to Maanshan and Angang in terms of valuation multiples. The main risk to our PT is lower-than-expected steel prices.

Reuters 0581.HK, Bloomberg 581 HK

Rmb in millions, year-end December

	2003	2004	2005	2006	2007E	2008E		
Sales	5,278	9,119	9,183	9,782	11,604	12,821	52-Week Range	1.49 - 2.37
Net profit	1,076	1,173	847	1,033	1,392	1,627	Mkt cap (HK\$ mm)	7,292
EPS(Rmb)	0.51	0.42	0.29	0.36	0.48	0.56	Mkt cap (US\$ mm)	936
EPS(Y/Y)	177%	-17%	-31%	22%	35%	17%	Free float	29%
BPS(Rmb)	0.45	1.40	1.58	1.89	2.28	2.73	AVG daily volume	4.6 mm
DPS(Rmb)	0.23	0.23	0.05	0.07	0.09	0.10	Shares outstanding(mm)	2,905
P/E	5.1	6.2	8.8	7.0	5.2	4.4	AVG daily volume (MM HKD)	10.9
P/B	5.8	1.9	1.6	1.3	1.1	0.9	AVG daily volume (MM USD)	1.4
EV/EBITDA	5.0	4.7	5.6	4.8	3.4	2.3	MSCI China	53
Dividend Yield	9%	9%	2%	3%	4%	4%	HK\$/US\$	7.79
ROE	168%	49%	20%	21%	23%	22%		
Net debt/equity	90%	-27%	-2%	7%	-2%	-15%		
<b>Performance</b>				<b>1mth</b>	<b>3mths</b>	<b>12 mths</b>		
Absolute (%)				0.0	34.2	47.6		
Relative to MSCI China(%)				-15.7	-37.6	3.7		

Source: Company data, Datastream and JPMorgan estimates.

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Overweight

HK\$2.51

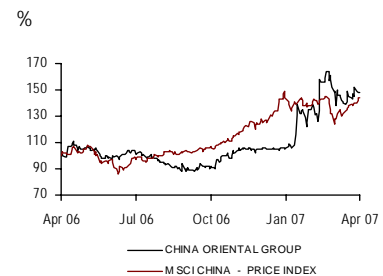
04 April 2007  
Price Target: HK\$3.30

Hong Kong  
Steel

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One-year relative performance



Source: Datastream.

## 2006 result in line with expectations

China Oriental's 2006 EPS came in at Rmb0.36, in line with our forecast. We overestimated the volume sales of CRC and H beam; thus the higher revenue estimate. But at the same time, our cost estimate was also higher than actual. The net impact is therefore not significant.

Table 1: FY06 result review

Rmb in millions

	2006A	2006JPM	Difference	2005A	Chg
Revenue	9,782	10,974	-11%	9,183	7%
COGS	8,358	9,503	-12%	7,959	5%
Gross profit	1,424	1,472	-3%	1,224	16%
SG&A	184	190	-3%	159	15%
EBIT	1,266	1,338	-5%	1,081	17%
EBT	1,233	1,254	-2%	1,005	23%
Tax	211	188	12%	157	34%
Minority	(10)	-11	-4%	1	-2063%
Net income	1,033	1,077	-4%	847	22%
EPS	0.36	0.37	-4%	0.29	22%

Source: Company and JPMorgan estimates.

We expect 2007 EPS to go up by 35% Y/Y and 2008 EPS up by 17% Y/Y as we expect higher ASP (up by 9% Y/Y due to higher product selling prices and better product mix), and higher volume growth (9% Y/Y).

Table 2: Major assumptions

	2004	2005	2006	2007E	2008E
ASP(Rmb/t)	2,694	2,753	2,611	2,848	2,937
Chg	24%	2%	-5%	9%	3%
CRC (Rmb/t)		3,826	3,578	3,833	3,908
Chg		-6%	7%	2%	
Volume sales('000 tons)	3,385	3,336	3,746	4,074	4,365
Chg	40%	-1%	12%	9%	7%
COGS(Rmb/t)	2,307	2,386	2,231	2,384	2,388
Chg	38%	3%	-6%	7%	0%
Margin(Rmb/t)	387	367	380	465	550
Chg	-24%	-5%	4%	22%	18%
Iron ore(Rmb/t)	710	735	629	665	619
Chg	70%	3%	-14%	6%	-7%
Coking coal(Rmb/t)	1,055	1,107	969	1,025	1,025
Chg	30%	5%	-12%	6%	0%

Source: Company and JPMorgan estimates.

We fine-tuned our model but this has not resulted in any major changes to our earnings forecasts. We raise our ASP forecasts by 1% but this is offset by higher cost estimates (up by 1% as well).

Table 3: What has changed?

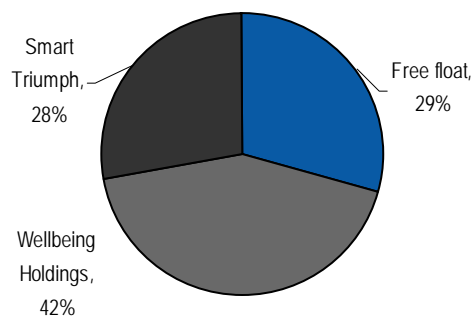
	2007E			2008E		
	Old	New	Change	Old	New	Change
Volume sales('000 tons)						
Billets	74	74	0%	65	65	0%
Narrow width strip	1,500	1,500	0%	1,600	1,600	0%
Mid width strip	1,300	1,300	0%	1,400	1,400	0%
H beam	1,000	1,000	0%	1,000	1,000	0%
CRC & Gal	200	200	0%	300	300	0%
Total	4,074	4,074	0%	4,365	4,365	0%
ASP (Rmb/t)	Old	New	Change	Old	New	Change
Billets	2,453	2,453	0%	2,528	2,528	0%
Narrow width strip	2,633	2,633	0%	2,708	2,708	0%
Mid width strip	2,708	2,708	0%	2,783	2,783	0%
H beam	3,053	3,053	0%	3,128	3,128	0%
CRC	3,833	3,833	0%	3,908	3,908	0%
Gal		5,000			5,000	
ASP	2,829	2,848	1%	2,921	2,937	1%
Cost(Rmb/t)						
COGS per ton	2,363	2,384	1%	2,355	2,388	1%
EPS (Rmb/share)	0.48	0.48	0%	0.56	0.56	0%

Source: JPMorgan estimates.

The second-largest shareholder, Smart Triumph, is in talks with the largest shareholder, Wellbeing Holdings, to gain a controlling stake of the company. We do not expect any material progress in the short term. The cheap valuation of the company's share price is the primary reason for the fight for the controlling stake.

It is unclear if Smart Triumph will buy in the open market to increase its holdings. We think it is likely that Smart Triumph will continue to negotiate with Wellbeing before making any move in the H share market.

Figure 1: Shareholders' structure



Source: Company.

### Positive outlook of steel prices

We expect China spot steel prices to go up by 5% Y/Y in 2007 and up by another 5% Y/Y in 2008 as supply growth to lag demand growth. And net exports should fall in 2007 and 2008.

Table 4: China steel supply and demand model

Tons in millions

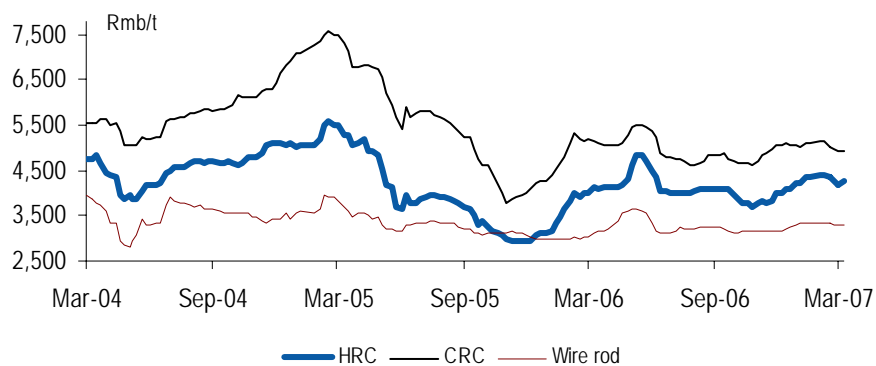
	Crude capacity	Change	Crude production	Change	Utilization rate	Net import	Apparent consumption	Change	HRC price(US\$/t)	Change	Inventory change
2002	230		180		78%	24	203		280		
2003	286	24%	219	22%	77%	36	255	26%	340	21%	Up
2004	356	24%	269	23%	76%	13	283	11%	470	38%	Down
2005	432	21%	348	29%	81%	0	348	23%	440	-6%	Up
2006	488	13%	422	21%	86%	-34	387	11%	425	-3%	Down
2007E	545	12%	475	13%	87%	-25	450	16%	445	5%	Up
2008E	580	6%	525	11%	91%	-15	510	13%	468	5%	Flat
2009E	597	3%	560	7%	94%	0	560	10%	478	2%	Flat

Source: JPMorgan estimates.

Spot prices are moving sideways. The Chinese government might cut steel export VAT rebate to zero from 8% for long products and HRC, and cut the rebate to 5% from 8% for CRC, galvanized steel and color-coated steel products. However, we think this is widely expected and the negative impact on steel prices might be only temporary.

Figure 2: China steel prices

Rmb/t, including VAT

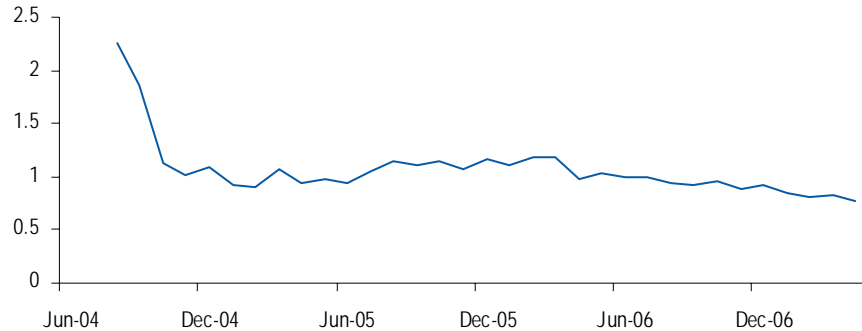


Source: www.mysteel.com.

## Valuation

We derive our Dec-07 price target of HK\$3.3 by applying 1.2x FY08E P/BV to FY08E BVPS, implying 31% upside. We feel that the company should trade above 1x P/BV during up-cycles. 1.2x P/E is about a 10% premium to China Oriental's historical average P/BV.

Figure 3: Historical one-year forward P/B



Source: Datastream and JPMorgan estimates.

China Oriental is trading at a huge discount to larger counterparts such as Maanshan and Angang. It is trading at a 46% discount to Maanshan and Angang's average in terms of 08E P/E, 51% discount in terms of EV/EBITDA, 53% discount in terms of P/B, with only 3% discount in terms of ROE.

Table 5: Steel companies' valuation comparison

	Maanshan			Angang			Average of Angang and Maanshan			China Oriental		
	06E	07E	08E	06E	07E	08E	06E	07E	08E	06E	07E	08E
P/E	16.6	11.6	7.6	13.0	11.1	8.7	14.8	11.3	8.1	7.0	5.2	4.4
P/B	1.8	1.7	1.5	3.1	2.7	2.4	2.5	2.2	1.9	1.3	1.1	0.9
EV/EBITDA	9.4	6.8	3.7	7.2	6.6	5.7	8.3	6.7	4.7	4.8	3.4	2.3
ROE (%)	11	16	21	34	26	29	23	21	25	21	23	22

Source: Company and JPMorgan estimates.

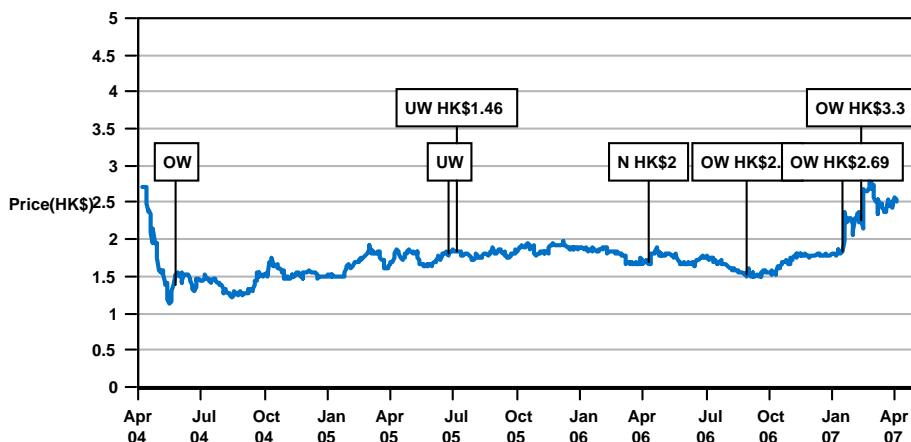
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China Oriental (0581.HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
24-May-04	OW	1.39	-
23-Jun-05	UW	1.82	-
07-Jul-05	UW	1.85	1.46
10-Apr-06	N	1.70	2.00
30-Aug-06	OW	1.52	2.20
16-Jan-07	OW	1.83	2.69
12-Feb-07	OW	2.25	3.30

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.  
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## China Oriental: Summary of financials

Rmb in millions, year-end December

Profit and Loss statement						Cash flow statement					
CNY in millions, year-end Dec	FY04A	FY05A	FY06A	FY07E	FY08E	CNY in millions, year-end Dec	FY04A	FY05A	FY06A	FY07E	FY08E
Revenues	9,119	9,183	9,782	11,604	12,821	EBIT	1,229	1,018	1,266	1,735	2,224
% change Y/Y	72.8	0.7	6.5	18.6	10.5	Depreciation & amortisation	150	297	315	348	378
Gross Margin (%)	14.4	13.3	14.6	16.3	18.7	Change in working capital	-469	269	-966	-462	-148
EBITDA	1,378	1,315	1,580	2,083	2,602	Taxes	30	-157	-211	-288	-543
% change Y/Y	9.1	-4.6	20.2	31.8	24.9	Cash flow from operations	393	620	381	1,277	1,857
EBITDA Margin (%)	15.1	14.3	16.2	17.9	20.3	Capex	-401	-850	-600	-500	-500
EBIT	1,229	1,018	1,266	1,735	2,224	Disposal/ (purchase)	0	0	0	0	0
% change Y/Y	5.3	-17.1	24.3	37.1	28.2	Net Interest	-64	-12	-31	-50	-50
EBIT Margin (%)	13.5	11.1	12.9	15.0	17.4	Free cash flow	-8	-230	-219	777	1,357
Net Interest	-64	-12	-31	-50	-50	Equity raised/ (repaid)	2,107	0	0	0	0
Earnings before tax	1,171	1,004	1,233	1,684	2,173	Debt raised/ (repaid)	-500	-249	-696	0	0
% change Y/Y	2.5	-14.3	22.8	36.5	29.1	Other	186	-585	0	0	0
Tax	30	157	211	288	543	Dividends paid	-625	-136	-192	-258	-258
as % of EBT	2.6	-15.6	-17.1	-17.1	-25.0	Beginning cash	153	2,925	1,725	530	1,049
Net Income (Reported)	1,173	847	1,033	1,392	1,627	Ending cash	2,925	1,725	530	1,049	2,148
% change Y/Y	9.0	-27.8	22.0	34.8	16.9	DPS	0.226	0.047	0.066	0.089	0.104
Shares Outstanding	2770	2905	2905	2905	2905						
EPS (reported)	0.424	0.291	0.355	0.479	0.560						
% change Y/Y	-17.4	-31.2	22.0	34.8	16.9						
Balance sheet						Ratio Analysis					
CNY in millions, year-end Dec	FY04A	FY05A	FY06A	FY07E	FY08E	%, year-end Dec	FY04A	FY05A	FY06A	FY07E	FY08E
Cash and cash equivalents	2,925	1,725	530	1,049	2,148	EBITDA margin	15.1	14.3	16.2	17.9	20.3
Accounts receivable	828	714	999	1,185	1,309	Operating margin	13.5	11.1	12.9	15.0	17.4
Inventories	900	1,103	1,408	1,636	1,756	Net profit margin	12.9	9.2	10.6	12.0	12.7
Others	412	253	484	575	635	SG&A/sales	15.1	14.3	16.2	17.9	20.3
Current assets	5,065	3,796	3,421	4,444	5,847	Sales per share growth	72.8	0.7	6.5	18.6	10.5
LT investments	0	0	0	0	0	Sales growth	72.8	0.7	6.5	18.6	10.5
Net fixed assets	2,349	4,236	4,675	4,674	4,796	Net profit growth	9.0	-27.8	22.0	34.8	16.9
Total assets	7,482	8,153	8,221	9,638	11,128	EPS growth	-17.4	-31.2	22.0	34.8	16.9
Liabilities						Interest coverage (x)	21.4	113.4	50.2	41.3	51.6
ST loans	1,420	1,336	573	573	573	Net debt to total capital	-14.2	-1.2	5.0	-1.2	-11.0
Payables						Net debt to equity	-26.9	-2.1	7.4	-1.7	-15.3
Others	1,577	1,929	1,802	1,828	1,976	Sales/assets	173.0	117.5	119.5	129.9	123.5
Total current liabilities	2997	3112	2203	2538	2700	Assets/equity	192.6	177.5	150.0	145.7	140.1
Long term debt	459	294	361	361	361	ROE	48.6	20.0	20.5	23.0	22.4
Other liabilities	25	15	56	0	0	ROCE	31.9	17.0	20.0	24.9	27.1
Total liabilities	3481	3421	2620	2899	3061						
Shareholders' equity	3885	4593	5479	6617	7944						
BVPS	1.403	1.581	1.886	2.278	2.735						

Source: Company data and JPMorgan estimates.