

China Oriental Group (581 HK)

Rating: 1

1H07 results review – benefited from a surge in the production of H-section steel

Materials: China

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Target price: HK\$3.80 (-3.3%)

Share price: HK\$3.93 (5 Sep)

Investment indicators

PER	(x; 07F)	7.0
	(x; 08F)	6.1
PCFR	(x; 07F)	7.0
	(x; 08F)	5.0
EV/EBITDA	(x; 07F)	5.0
	(x; 08F)	3.4
Dividend yield	(x; 07F)	2.3
PBR	(x; 06)	2.1
ROE	(x; 06)	18.8

Source: Daiwa forecasts

Performance (%)

	1M	3M	6M
Absolute	11.3	31.0	56.6
Relative	4.3	13.4	21.4

Source: Daiwa

Note: Relative to HSI

Income summary (Rmb m)

Yr to 31 Dec	2006	2007F	2008F
Revenue	9,782	13,066	15,102
YoY (%)	6.5	33.6	15.6
EBITDA	1,668	2,280	3,140
YoY (%)	30.1	36.7	37.7
Op. income	1,359	1,971	2,831
Net income	1,033	1,570	1,822
YoY (%)	22.0	52.0	16.1
EPS (Rmb)	0.356	0.540	0.627

Source: Company, Daiwa forecasts

Investment summary

China Oriental Group's (COG) 1H07 net profit of Rmb769m equated to 49% of our full-year FY07 forecast, but was 11% lower than our 1H07 forecast, as we underestimated the cost of production. The company's net profit surged 32% YoY, on the back of a 22% YoY increase in the ASP, as well as a 15% YoY increase in sales volume. COG announced an interim DPS of HK\$0.01, the same as that for 1H06. Despite the surge in the cost of production, the company's margins were in line with our expectations, mainly because its newly commissioned H-section mill was more profitable than we expected. We maintain our **1 (Buy)** rating, as we remain positive about the outlook for H-section steel, and are of view that FY08 earnings growth will be driven by capacity expansion from a new H-section mill. We are reviewing our earnings forecasts and target price.

Fundamentals

- We were pleased with COG's 1H07 H-section performance. Not only was its sales volume was 27% higher than our forecast, the gross margin was 22% for its first year of operation, and higher than the 9.8% gross margin recorded by Maanshan Iron & Steel (323 HK, HK\$6.75, 1) during the period. The H-section mill has a designed capacity of 1m t.p.a. COG expects its production capacity for the whole of FY07 to increase by 30% to 1.3m tonnes, 30% higher than we had expected.
- COG announced that it has already started construction of a second H-section mill with a designed capacity of 1.2m t.p.a. In our view, it is possible that this mill can commence production in mid 2008. As a result, we estimate that COG's total production capacity could increase by 27% from 4.5m t.p.a. currently to 5.7m t.p.a. in FY08. In addition, we think that COG will benefit from the rising ASPs of H-section steel going into FY08, in view of the ongoing infrastructure and real-estate construction boom in China.

COG: 1H07 results summary and comparison with our forecasts

	1H06	1H07	% YoY	1H07F	Variance (%)
Sales volume (m tonnes)	1.91	2.19	14.6	2.12	3
<i>Jinxi Total</i>	1.86	2.12	13.8	2.01	6
<i>Billets</i>	0.85	0.11	(86.7)	0.20	(44)
<i>Strips</i>	1.01	1.37	35.9	1.31	5
<i>H-section</i>	-	0.63	n.a.	0.50	27
<i>Foshan Jinlan (60% stake)</i>	0.05	0.07	47.8	0.12	(39)
<i>Cold-rolled steel</i>	0.04	0.01	(83.0)	0.04	(86)
<i>Galvanized steel</i>	0.01	0.07	432.3	0.08	(11)
ASP (Rmb/tonne)	2,497	3,033	21.5	3,119	(3)
<i>Billets</i>	2,331	2,519	8.1	2,536	(1)
<i>Strips</i>	2,564	2,825	10.2	2,795	1
<i>H-section</i>	n.a.	3,325	n.a.	3,792	(12)
<i>Cold-rolled steel</i>	3,600	4,567	26.9	3,757	22
<i>Galvanized steel</i>	5,100	5,113	0.2	5,207	(2)
Gross-profit margin					
<i>Billets (%)</i>	16.0	11.9			
<i>Strips (%)</i>	19.3	15.2			
<i>H-section</i>	n.a.	21.8			
Revenue (Rmb m)	4,774	6,648	39.3	6,628	0
Cost of production (Rmb m)	3,977	5,559	39.8	5,441	2
Unit cost of production (Rmb/tonne)	2,080	2,536	21.9	2,561	(1)
Net profit (Rmb m)	585	769	31.5	860	(11)
EPS (Rmb)	0.201	0.265	31.5	0.296	(11)
Gross-profit margin (%)	16.7	16.4		17.9	(0.8)
Net-profit margin (%)	12.2	11.6		13.0	(0.9)

Source: Company, Daiwa forecasts

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