China Oriental

1H results better than expected; maintain OW

- **We raise our earnings forecast:** China Oriental reported better-than-expected 1H07 earnings; EPS at Rmb0.26 was 9% higher than our estimate, up by 30% Y/Y. We raise our FY07E and FY08E EPS by 8% and 7%, respectively, and maintain OW. Management has proposed Rmb0.055/share interim dividend, pending approval from Securities and Futures Commission.
- **Earnings up on higher steel prices, volume expansion:** ASP increased by about 25%, and COGS/t by 26%, resulting in a slightly lower gross margin (16.4%) than in FY06 (16.7%). Net profit grew on volume growth and product mix improvement. This confirms our view that steel companies' net profits normally increase as long as steel prices keep rising, despite rising costs.
- **Potential catalysts, share price drivers:** We expect that China Oriental will maintain the 1H07 profitability, despite rising raw material costs in 2H07. Iron ore and coke combined costs are up by about Rmb360/t than in 1H07. Steel prices (H beam and strips) increased by Rmb200/t and Rmb600/t, respectively, enough for the company to offset the impact of rising costs. We are positive on the outlook of steel prices in China in the next 2 years (up by 8% in FY08E and 5% in FY09E).
- **Price target, valuation, key risks:** We raise our PT by 40% to HK$4.6 (from HK$3) by applying 7.5x P/E to FY08E EPS of Rmb0.6/share. Key risks to our PT are lower-than-expected steel prices and the dragging dispute between the largest and second largest shareholders over the controlling stake.

Overweight

HK$3.80

06 September 2007
Price Target: HK$4.60

Hong Kong
Steel

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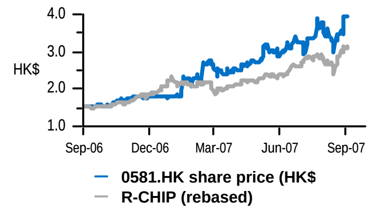
Price Performance



	YTD	-1M	-3M	-12M
Absolute	118.3%	11.3%	31.0%	156.9%
Relative	80.1%	-0.5%	1.4%	53.7%

Source: RIMES, Reuters.

Reuters 0581.HK; Bloomberg: 581

RmbMM; Y/E Dec	2002	2003	2004	2005	2006E	2007E	2008E
Sales	2,571	5,278	9,119	9,183	9,782	12,636	14,704
NP	388	1,076	1,173	847	1,033	1,499	1,742
EPS (Rmb)	0.18	0.51	0.42	0.29	0.36	0.52	0.60
EPS (Y/Y) (%)	152	177	-17	-31	22	45	16
BPS (Rmb)	0.16	0.45	1.40	1.58	1.89	2.30	2.77
DPS (Rmb)	0.18	0.23	0.23	0.05	0.07	0.10	0.11
P/E	20.8	7.5	9.1	12.9	10.4	7.0	6.0
P/B	23.9	8.6	2.7	2.4	2.0	1.6	1.3
EV/EBITDA	12.3	7.1	7.4	8.2	7.1	4.7	3.5
Dividend yield	5	6	6	1	2	3	3
ROE	115	168	49	20	21	25	24
Net debt/equity	69	90	-27	-2	7	-1	-14

52-week range	1.49 - 3.93
Mkt cap (HK$MM)	10,749
Mkt cap (US$MM)	1379
Free float (%)	29%
Avg daily vol (MM)	4.6
Shares ostng (MM)	2,905
MSCI China	74
HK$/US$	7.79

Source: Bloomberg, JPMorgan estimates.

See page 5 for analyst certification and important disclosures, including investment banking relationships.

1H results better than expected

China Oriental reported better-than-expected results. EPS came in at Rmb0.26/share, 9% higher than our estimate and up by 30% Y/Y. Earnings were higher than our expectation due to higher steel selling prices and better product mix. Costs were also higher. Cost increases were, however, partially offset by higher revenues.

ASP increased by about 25% and COGS/t by 26%, resulting in a slightly lower gross margin (16.4%) than in FY06 (16.7%). Net profit grew on volume growth and product mix improvement. This confirms our view that steel companies' net profits normally grow as long as steel prices keep rising, despite rising costs.

Table 1: 1H07 results vs. JPMorgan estimates and 1H06 actual

Rmb in millions

	1H07A	1H07E	% diff	1H06A	% diff
Net profit	6,648	5,802	15%	4,774	39%
COGS	5,559	4,855	14%	3,977	40%
Gross profit	1,089	947	15%	797	37%
SG&A	(127)	109	-216%	93	-236%
Operating Profit	963	868	11%	726	33%
EBT	937	842	11%	700	34%
Net profit	788	696	13%	585	35%
EPS	0.26	0.24	9%	0.20	29%

Source: Company data, JPMorgan estimates.

The company has started to expand its H beam capacity by 1.2MM tons with a capex of Rmb564MM. Management believes that it will likely get the government's approval on this project before it is completed.

China Oriental's management also expects to expand total steel capacity by 150% to 10MM tons from 4MM tons by 2010, through organic growth and mergers and acquisitions.

Revising earnings estimates

We revise up our FY07 and FY08 EPS estimates by 8% to Rmb0.52/share and 7% to Rmb0.6/share, respectively, as we also revise up our steel selling prices estimates.

Table 2: Major assumptions

	2003	2004	2,005	2006E	2007E	2008E
ASP(Rmb/t)	2,180	2,694	2,753	2,611	3,102	3,369
		24%	2%	-5%	19%	9%
CRC (Rmb/t)			3,826	3,578	4,185	4,375
				-6%	17%	5%
Volume sales('000 tons)	2,421	3,385	3,336	3,746	4,074	4,365
		40%	-1%	12%	9%	7%
COGS(Rmb/t)	1,671	2,307	2,386	2,231	2,607	2,796
		38%	3%	-6%	17%	7%
Margin(Rmb/t)	509	387	367	380	495	573
		-24%	-5%	4%	30%	16%
Iron ore(Rmb/t)	418	710	735	629	788	840
		70%	3%	-14%	25%	7%
Coking coal(Rmb/t)	809	1,055	1,107	969	1,118	1,095
		30%	5%	-12%	15%	-2%

Source: JPMorgan estimates, company data

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The company declared an Rmb0.055/share interim dividend, pending approval from HK Securities and Futures Commission, as Ms Chen Ningning, Executive Director of the Board, voted against such a proposal.

Valuations

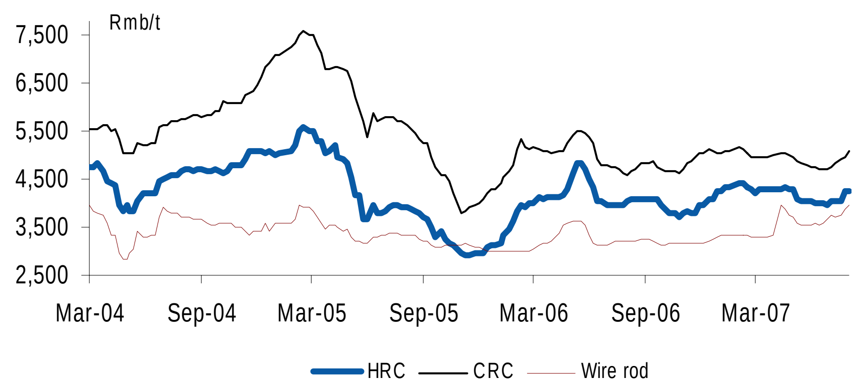
We derive our new June 2008 price target of HK$4.6/share by applying 7.5x P/E to FY08E EPS of Rmb0.6/share. 7.5x P/E represents about a 35% discount to the global average 11.5 x P/E. We used a discount to the global average due to concerns of about the dragging dispute between largest shareholder and second largest shareholder on controlling stake.

Rising steel prices

Steel prices in China have risen in recent weeks and we expect demand growth to outpace supply. The country's exports were very strong in 1H, which has resulted in insufficient supply to the domestic market and a low domestic steel inventory.

Figure 1: China—Steel prices

Rmb/t VAT incl.



Source: Mysteel.

Figure 2: Shanghai—Steel inventory

Source: Mysteel.

Table 3: China—Steel supply and demand model

In million tons

	Crude Capacity	Chg	Crude Prod	Chg	Utilization rate	Net import	Apparent consumption	Chg	HRC price (US$/t)	Chg	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	388	12%	425	-3%	Down
2007E	545	12%	495	17%	91%	-40	455	17%	445	5%	Up
2008E	585	7%	540	9%	92%	-25	515	13%	468	8%	Flat
2009E	615	5%	580	7%	94%	-5	575	12%	478	5%	Flat

Source: JPMorgan estimates.

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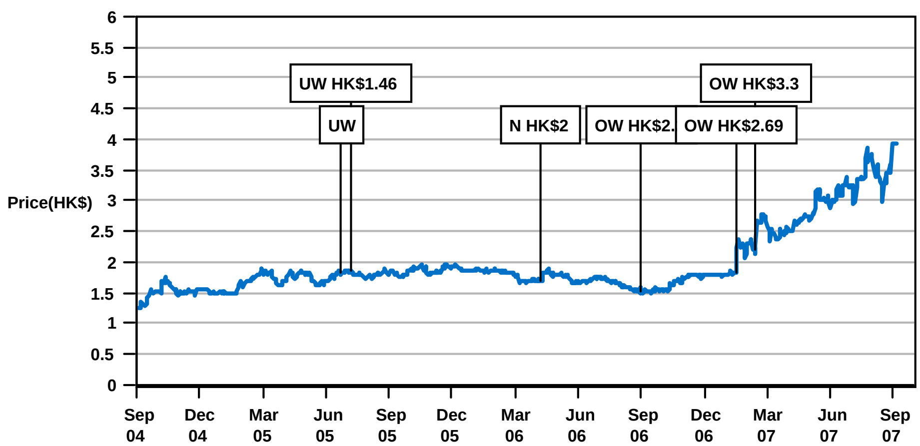
China Oriental (0581.HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
23-Jun-05	UW	1.82	-
07-Jul-05	UW	1.85	1.46
10-Apr-06	N	1.68	2.00
30-Aug-06	OW	1.52	2.20
16-Jan-07	OW	1.83	2.69
12-Feb-07	OW	2.22	3.30

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

Profit and loss statement

CNY in millions, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E
Revenues	9,119	9,183	9,782	12,636	14,704
% change Y/Y	72.8	0.7	6.5	29.2	16.4
Gross margin (%)	14.4	13.3	14.6	16.0	17.0
EBITDA	1,378	1,315	1,580	2,192	2,679
% change Y/Y	9.1	-4.6	20.2	38.7	22.2
EBITDA margin (%)	15.1	14.3	16.2	17.3	18.2
EBIT	1,229	1,018	1,266	1,844	2,301
% change Y/Y	5.3	-17.1	24.3	45.7	24.8
EBIT margin (%)	13.5	11.1	12.9	14.6	15.6
Net interest	-64	-12	-31	-50	-50
Earnings before tax	1,171	1,004	1,233	1,793	2,250
% change Y/Y	2.5	-14.3	22.8	45.4	25.5
Tax	30	157	211	307	562
as % of EBT	2.6	-15.6	-17.1	-17.1	-25.0
Net income (reported)	1,173	847	1,033	1,499	1,742
% change Y/Y	9.0	-27.8	22.0	45.1	16.2
Shares outstanding (MM)	2770	2905	2905	2905	2905
EPS (reported) (CNY)	0.424	0.291	0.355	0.516	0.600
% change Y/Y	-17.4	-31.2	22.0	45.1	16.2

Cash flow statement

CNY in millions, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E
EBIT	1,229	1,018	1,266	1,844	2,301
Depreciation & amortization	150	297	315	348	378
Change in working capital	-469	269	-966	-620	-291
Taxes	30	-157	-211	-307	-562
Cash flow from operations	393	620	381	1,226	1,828
Capex	-401	-850	-600	-500	-500
Disposal/ (purchase)	0	0	0	0	0
Net interest	-64	-12	-31	-50	-50
Free cash flow	-8	-230	-219	726	1,328
Equity raised/ (repaid)	2,107	0	0	0	0
Debt raised/ (repaid)	-500	-249	-696	0	0
Other	186	-585	0	0	0
Dividends paid	-625	-136	-192	-278	-278
Beginning cash	153	2,925	1,725	530	978
Ending cash	2,925	1,725	530	978	2,028
DPS (CNY)	0.226	0.047	0.066	0.096	0.111

Balance sheet

CNY in millions, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E
Cash and cash equivalents	2,925	1,725	530	978	2,028
Accounts receivable	828	714	999	1,290	1,501
Inventories	900	1,103	1,408	1,789	2,056
Others	412	253	484	626	728
Current assets	5,065	3,796	3,421	4,683	6,313
Long-term investments	0	0	0	0	0
Net fixed assets	2,349	4,236	4,675	4,674	4,796
Total assets	7,482	8,153	8,221	9,860	11,519
Liabilities					
Short-term loans	1,420	1,336	573	573	573
Payables					
Others	1,577	1,929	1,802	1,967	2,238
Total current liabilities	2997	3112	2203	2690	2984
Long-term debt	459	294	361	361	361
Other liabilities	25	15	56	0	0
Total liabilities	3481	3421	2620	3050	3345
Shareholders' equity	3885	4593	5479	6687	8051

Ratio analysis

%, year-end Dec	FY04A	FY05A	FY06E	FY07E	FY08E
EBITDA margin	15.1	14.3	16.2	17.3	18.2
Operating margin	13.5	11.1	12.9	14.6	15.6
Net profit margin	12.9	9.2	10.6	11.9	11.8
SG&A/sales	15.1	14.3	16.2	17.3	18.2
Sales per share growth	72.8	0.7	6.5	29.2	16.4
Sales growth	72.8	0.7	6.5	29.2	16.4
Net profit growth	9.0	-27.8	22.0	45.1	16.2
EPS growth	-17.4	-31.2	22.0	45.1	16.2
Interest coverage (x)	21.4	113.4	50.2	43.5	53.2
Net debt to total capital	-14.2	-1.2	5.0	-0.5	-9.6
Net debt to equity	-26.9	-2.1	7.4	-0.7	-13.6
Sales/assets	173.0	117.5	119.5	139.8	137.6
Assets/equity	192.6	177.5	150.0	147.4	143.1
ROE	48.6	20.0	20.5	24.6	23.6
ROCE	31.9	17.0	20.0	26.3	27.7

Source: Company, JPMorgan estimates.