

Upgrade to Buy; New strategic investor -- Arcelor Mittal

Equity | China | Steels
07 November 2007



Merrill Lynch

Alexander Latzer >>

+852 2536 3453

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

Irene Ye >>>

Research Analyst
Irene_Ye@ml.com

Raising rating to Buy with a P.O. of HK\$6.80/sh

Arcelor Mittal is buying a strategic 28% stake from the second largest shareholder and former non-executive Board Member, Ms. Chen. We see the investment as a positive catalyst for the shares and are raising our rating from Neutral to Buy.

Investment should further reduce historic discount

Arcelor Mittal is reportedly paying US\$647M or HK\$6.16/sh equal to 11x our 2008 EPS est. Our Price Objective of HK\$6.80/sh is based on 12x and a 10% discount to the peer group, which is reasonable given competitive margins (EBIT 16% vs. 21% for Angang, 15% for Baosteel) and future growth potential with Arcelor Mittal. We look for upside from this valuation with positive changes to its growth strategy.

What is the history and where can COGC go?

China Oriental (581 HK) – COGC, based in China, supplies mainly the bldg. and const. market with high value H beams and other long products, and some flat steel via a JV, with a total cap. ~4.5M t. The shares underperformed until earlier this year when Ms. Chen attempted to take control.

The discount is due to a small scale of operations, emphasis on long products, and in particular a low profile strategy, which has resulted in low trading liquidity (US\$2B market value, and trading liquidity US\$3.7M). We believe more could be done with aggressive leadership to raise its profile and drive value added growth.

Potential for future growth, co-operation

We see many areas of potential co-operation, from raw materials supply and purchasing, to capital infusion, technology, and M&A. Shareholder expectations were raised with Ms. Chen and are now many notches higher. It is in the majority shareholder Chairman Han's interest to work with his new strategic investor.

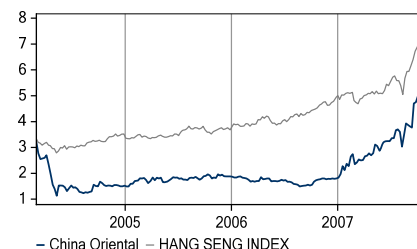
Rationale from perspective of Arcelor Mittal

Despite the small investment (~0.5% of EV), it is consistent with Arcelor Mittal's objective to become more significant in China and India. Foreign companies are currently limited to minority positions in Chinese steel companies. Clearly, Arcelor Mittal continues to be a driver/proponent of steel industry consolidation.

Arcelor Mittal does have a 29.19% stake in Hunan Valin Steel Tube & Wire, but its investment in Laiwu has been on hold awaiting gov.'t approvals. The 28% stake in COGC is an ideal way to pick up a strategic position as it is not Chinese state owned (45.1% owned by Chairman Mr. Han, recently increased from 42.4%).

Stock Data

Price	HK\$5.40
Price Objective	HK\$6.80
Date Established	7-Nov-2007
Investment Opinion	C-2-7 to C-1-7
Volatility Risk	HIGH
ML Symbol / Exchange	CUGCF / HKG
Bloomberg / Reuters	581 HK / 0581.HK



>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

>>> Licensed by The Securities and Futures Commission of Hong Kong and not registered/qualified as a research analyst under the NYSE/NASD rules.

Refer to "Other Important Disclosures" for information on certain Merrill Lynch entities that take responsibility for this report in particular jurisdictions.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 4 to 5. Analyst Certification on page 3.

Upside potential, raising rating Buy

Investment should further reduce historic discount

Our Price Objective of HK\$6.80/sh is based on a P/E ratio of 12x on 2008 EPS equal to a 10% discount to the peer group, which is reasonable given COGC's competitive margins (EBIT 16% vs. 21% for Angang, 15% for Baosteel) and future growth potential with its new strategic partner. We look for upside from this valuation with positive changes to its growth strategy.

Potential benefits from Arcelor Mittal

We see many areas of potential co-operation, from raw materials supply and purchasing, to capital infusion, technology, and M&A. For example, COGC discussed doubling its capacity to 10M t by 2010 in its interim report. This initiative, which seemed unfeasible at the time, would have more credibility with the support of Arcelor Mittal.

COGC imports about 20% of its iron ore requirement and the remainder from the domestic market at spot. COGC could benefit from any iron ore that Arcelor Mittal could potentially supply from abroad to help diversify sources and reduce purchasing costs. COGC sells nearly exclusively to the domestic Chinese market. With increasing high value H beams and Arcelor Mittal's participation, China Oriental could explore overseas markets to broaden its client base to help its marketing position.

New H Beam line on stream sooner than expected

COGC's new 1.2M t per year H beam line is likely to commence production in the second quarter of 2008, about half a year earlier than expected. We see this as a potential positive to help offset the impact of rising raw materials costs by further raising margins and profits.

Table 1: Company overview figures

		2006A	2007E	07E vs. 06A	2008E	08E vs. 07E	2009E	09E vs. 08E	1H07A	1H06A	YoY	2H06A	HoH
Sales Volumes:	'000 t												
Billets		1,173	200	-83%	300	50%	0	-100%	113	853	-87%	320	-65%
Strips and strip products		2,202	2,800	27%	2,800	0%	2,800	0%	1,373	1,010	36%	1,192	15%
H-Sections		<u>250</u>	<u>1,300</u>	420%	<u>1,300</u>	0%	<u>2,020</u>	55%	<u>633</u>	<u>0</u>	NA	<u>250</u>	153%
Total steel products (except CR)		3,625	4,300	19%	4,400	2%	4,820	10%	2,119	1,863	14%	1,762	20%
CRC-JV		45	16	-65%	40	155%	60	50%	6	37	-83%	8	-21%
Galvanized		77	147	91%	160	9%	200	25%	67	13	432%	64	4%
Profit & Loss Statement													
Revenue	Rmb mn	9,782	13,376	37%	14,188	6%	16,214	14%	6,648	4,710	41%	5,072	31%
COGS		<u>-8,358</u>	<u>-11,286</u>	35%	<u>-11,703</u>	4%	<u>-13,235</u>	13%	<u>-5,559</u>	<u>-3,977</u>	40%	<u>-4,381</u>	27%
Gross profit		1,424	2,091	47%	2,484	19%	2,979	20%	1,089	734	48%	690	58%
SG&A		<u>-184</u>	<u>-229</u>	25%	<u>-242</u>	6%	<u>-277</u>	14%	<u>-114</u>	<u>-93</u>	22%	<u>-90</u>	26%
EBIT		1,241	1,862	50%	2,242	20%	2,702	21%	976	641	52%	600	63%
Interest income		19	14	-27%	12	-11%	28	127%	5	13	-59%	6	-14%
Interest expense		-50	-73	45%	-73	0%	-73	0%	-31	-23	32%	-27	13%
Investment income		-1	0	-100%	0	NA	0	NA	-1	-2	-74%	1	-145%
Others		<u>25</u>	<u>0</u>	-100%	<u>0</u>	NA	<u>0</u>	NA	<u>-13</u>	<u>72</u>	-118%	<u>-47</u>	-72%
Profit Before Tax		1,233	1,803	46%	2,181	21%	2,657	22%	937	700	34%	533	76%
Income Tax		<u>-211</u>	<u>-308</u>	46%	<u>-545</u>	77%	<u>-664</u>	22%	<u>-148</u>	<u>-111</u>	34%	<u>-100</u>	48%
Profit After Tax		1,022	1,494	46%	1,636	9%	1,993	22%	788	590	34%	433	82%
Minorities		<u>10</u>	<u>-37</u>	-455%	<u>-40</u>	9%	<u>-49</u>	22%	<u>-19</u>	<u>-5</u>	NA	<u>15</u>	-227%
Net Income		<u>1,033</u>	<u>1,457</u>	41%	<u>1,595</u>	9%	<u>1,943</u>	22%	<u>769</u>	<u>585</u>	32%	<u>448</u>	72%
EPS	Rmb/sh	0.36	0.50	41%	0.55	9%	0.67	22%	0.26	0.20	32%	0.15	72%
DPS	Rmb/sh	0.06	0.10	80%	0.11	9%	0.17	52%	0.06	0.01	437%	0.05	21%

Source: China Oriental Group; ML estimates.

Price objective basis & risk

China Oriental (CUGCF)

Our Price Objective of HK\$6.80/sh is based on a P/E ratio of 12x on 2008E EPS equal to a 10% discount to the peer group, which is reasonable given COGC's competitive margins (EBIT 16% vs. 21% for Angang, 15% for Baosteel) and future growth potential with its new strategic partner. We look for upside from this valuation with positive changes to its growth strategy.

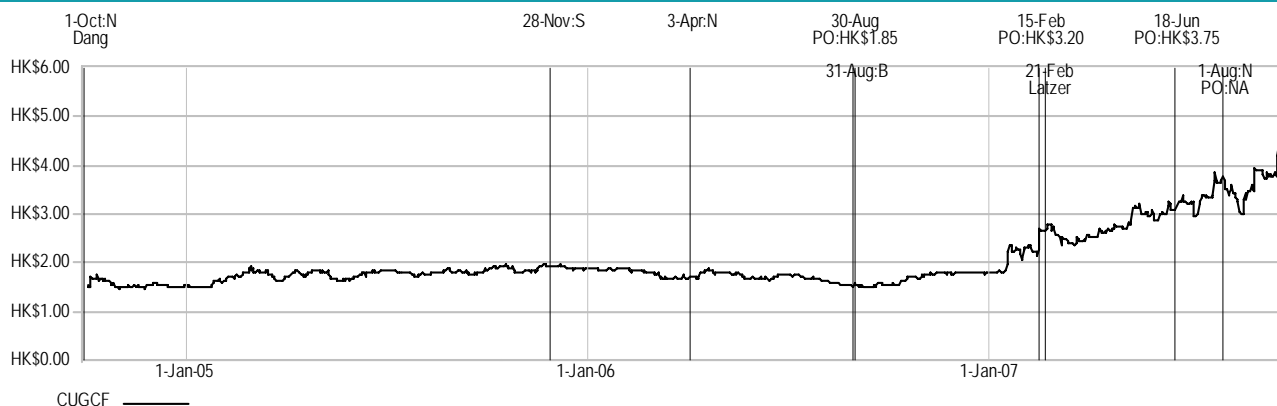
Risks to our recommendation are lower than forecast steel prices and higher than forecast costs, disruptions to plants and current expansions, slower than forecast economic growth, and the failure of Arcelor Mittal to complete its purchase of a stake in the company.

Analyst Certification

I, Alexander Latzer, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Important Disclosures

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 September 30, 2007 or such later date as indicated.

Investment Rating Distribution: Steel Group (as of 01 Oct 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	31	65.96%	Buy	3	12.00%
Neutral	15	31.91%	Neutral	3	21.43%
Sell	1	2.13%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 01 Oct 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1701	47.03%	Buy	437	29.15%
Neutral	1611	44.54%	Neutral	425	29.11%
Sell	305	8.43%	Sell	58	21.09%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. **INVESTMENT RATINGS**, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. **INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale: China Oriental.

MLPF&S or an affiliate expects to receive or intends to seek compensation for investment banking services from this company within the next three months: China Oriental.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.: Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow; Merrill Lynch (Turkey): Merrill Lynch Yatirim Bankasi A.S.; Merrill Lynch (Dubai): Merrill Lynch International Bank Ltd, Dubai Branch.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; is issued and distributed in India by DSP Merrill Lynch Limited; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) distributes this report in Germany. Merrill Lynch (Frankfurt) is regulated by BaFin.

Copyright, User Agreement and other general information related to this report:

Copyright 2007 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.