29 November 2007 (No. of pages: 9)

China Oriental Group (581 HK)

6-mth rating: 1
Target price: HK$7.25 (+34.3%)
Share price: HK$5.40 (28 Nov)

Materials: China

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Improved fundamentals and promising prospects thanks to ArcelorMittal

- We have raised our six-month target price for China Oriental Group (COG) from HK$3.80 to HK$7.25, based on a 9x PER on our new FY08 earnings forecast. We argue that COG deserves to trade at a higher valuation than its peak-cycle PER valuation of 5.9x, which we had used as a benchmark previously, in view of its improved fundamentals from the commissioning of its new H-beam lines, as well as its promising prospects, given the potential further investment by ArcelorMittal. Our target price represents 34% upside potential from the current price, hence we maintain our **1** (*Buy*) rating on the stock.

- We have revised up our FY08 revenue forecast by 25%, on the back of our expectation of higher sales volume and good pricing prospects due to strong demand for H beams and billets. We have also raised our FY08 unit-cost-of-production assumption in view of the surge in raw-material costs, but the increase is slight given the company's less exposure to freight costs than other integrated steel mills located further away from domestic feedstock markets.

- In our view, ArcelorMittal paying not less than HK$6.12/share to acquire the 45% interest from the chairman would be a share-price catalyst. We believe COG's fundamentals would be boosted strongly by the backing of ArcelorMittal in the areas of technology upgrades, further capacity expansion, and cheaper raw-material procurement. In addition, COG would benefit from the world-class management, operational experience and global M&A expertise of ArcelorMittel over the long term, in our view.

Reuters code		0581.HK

Market data

HSI		27,371.24
Market cap	(US$bn)	2.03
EV	(US$bn; 07F)	2.0
3-mth avg daily T/O	(US$m)	2.02
Shares outstanding	(m)	2,927
Free float	(%)	27.1
Major shareholder	Wellbeing Holdings Ltd. (42.8%)	
Exchange rate	Rmb/US$	7.394
	HK$/US$	7.787

Performance (%)*	**1M**	**3M**	**6M**
Absolute	3.1	53.8	80.0
Relative	14.5	31.3	35.0

Source: Daiwa
Note: *Relative to HSI

Investment indicators

PER	(x; 07F)	9.2
	(x; 08F)	6.7
PCFR	(x; 07F)	10.1
	(x; 08F)	6.2
EV/EBITDA	(x; 07F)	6.5
	(x; 08F)	4.4
PBR	(x; 07F)	2.1
	(x; 08F)	1.5
Dividend yield	(%; 07F)	1.8
	(%; 08F)	2.5
ROE	(%; 07F)	25.4
ROA	(%; 07F)	16.4
Net debt equity	(%; 07F)	6.4

Source: Daiwa forecasts

Income summary

	Revenue		EBITDA		Net profit		EPS		CFPS	DPS
Year to 31 Dec	**(Rmb m)**	**(%)**	**(Rmb m)**	**(%)**	**(Rmb m)**	**(%)**	**(Rmb)**	**(%)**	**(Rmb)**	**(Rmb)**
2005	9,182.7	0.7	1,282.0	n.a.	846.6	(28.3)	0.291	(32.2)	0.581	0.047
2006	9,782.1	6.5	1,667.9	30.1	1,032.8	22.0	0.356	22.0	0.875	0.058
2007F	14,507.6	48.3	2,299.8	37.9	1,572.0	52.2	0.537	51.1	0.491	0.090
2008F	18,845.8	29.9	3,377.5	46.9	1,964.8	25.0	0.671	25.0	0.729	0.112
2009F	21,361.7	13.3	4,020.3	19.0	2,402.6	22.3	0.821	22.3	0.887	0.137

Source: Company, Daiwa forecasts

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Investment summary

Earnings-forecast revisions

We have revised up our FY08 earnings forecast by 8%, on the back of our expectation of higher sales and better billet and H-beam prices in FY08, despite having factored in a surge in the cost of production during the period.

COG: Daiwa earnings-forecast revisions

	2006	2007F	2008F	2009F
Revenue	**9,782**	**14,508**	**18,846**	**21,362**
% YoY		48	30	13
Previous forecast		13,066	15,102	16,923
% change in forecast		11	25	26
Bloomberg forecast		12,851	14,903	16,923
% variance in forecast		13	26	26
Net profit	**1,033**	**1,572**	**1,965**	**2,403**
% YoY		52	25	22
Previous forecast		1,570	1,822	2,389
% change in forecast		0	8	1
Bloomberg forecast		1,534	1,782	999
% variance in forecast		2	10	141
EPS	**0.356**	**0.537**	**0.671**	**0.821**
% YoY		51	25	22
Previous forecast		0.540	0.627	0.822
% change in forecast		(1)	7	0
Bloomberg forecast		0.528	0.614	0.344
% variance in forecast		2	9	139

Source: Company, Daiwa forecasts

Valuation benchmark raised

The stock is trading currently at a PER of 6.7x on our FY08 EPS forecast, undemanding, in our view, given the 10.8x PER valuation ArcelorMittal paid to acquire its 28% of shareholding from the ex-second largest shareholder.

ArcelorMittal paid US$460/tonne to acquire 28% of COG

Key assumptions		
Rmb/US$		7.4
Rmb/HK$		0.95
FY07 net-profit Daiwa forecast	Rmb m	1,572
FY08 net-profit Daiwa forecast	Rmb m	1,965
Total shares	m shares	2,927
COG FY07 production capacity	m tonnes	5
ArcelorMittal paid US$460/tonne or a 10.8x PER to acquire 28% of COG		
Price per share paid to acquire 28%	HKD/share	6.12
Implied acquisition cost	Rmb m	17,018
Implied acquisition cost	US$m	2,300
Unit acquisition cost	US$/tonne	460
PER paid on FY07 earnings		10.8

Source: Daiwa estimate, Bloomberg

We argue that COG should trade at a higher multiple valuation than its peak-cycle PER valuation of 5.9x, on which we set our previous target price, because we believe its fundamentals have improved on the back of the commissioning of the new H-beam lines, as well its rosy prospects assuming the further investment by ArcelorMittal goes ahead. Our new target price is HK$7.25, and is based on a 9x PER on our FY08 EPS forecast, or a 17% discount to the valuation that ArcelorMittal paid to acquire its 28% shareholding.

Upside potential

In our view, further share-price upside potential would depend on how much ArcelorMittal ends up paying for the 45% shareholding in COG, if China's government approves the deal. On our estimates, ArcelorMittal paid HK$6.12 or US$460/tonne to acquire its 28% shareholding. To acquire the rest of the stake, ArcelorMittal would not be permitted to pay less than HK$6.12/share or US$460/tonne, according to the Take Over Code of the Hong Kong Stock Exchange. Mittal paid US$590/tonne to acquire Arcelor in FY06. If ArcelorMittal paid the same price, US$590/tonne, to acquire COG, then it should pay as high as HK$7.9 per share, which is equivalent to an FY08 PER of around 11x, not demanding, in our view, as it would fall within the PER valuation range (10-13x) of the Hong Kong-listed Chinese steel stocks.

How much is ArcelorMittal likely to pay for 45% of COG?

Unit acquisition cost	US$/tonne	590	570	550	530	510	490	470	460
Total acquisition cost	US$m	2,950	2,850	2,750	2,650	2,550	2,450	2,350	2,300
Total acquisition cost	Rmb m	21,830	21,090	20,350	19,610	18,870	18,130	17,390	17,018
Price to be paid per share	Rmb/share	7.5	7.3	7.0	6.8	6.5	6.2	6.0	5.8
Price to be paid per share	HK$/share	**7.9**	**7.64**	**7.37**	**7.11**	**6.84**	**6.57**	**6.30**	**6.12**
FY07F PER	(x)	13.9	13.4	12.9	12.5	12.0	11.5	11.1	10.8
FY08F PER	(x)	11.1	10.7	10.4	10.0	9.6	9.2	8.8	8.7

Source: Daiwa estimates

Improved fundamentals

Higher production utilisation

We have revised up our sales-volume forecasts for FY08 and FY09 by 4% for each year, as we expect the company's H-beam mill to record a high utilisation rate. We now forecast H-beam sales to increase to 1.8m tonnes and 2.4m tonnes, for FY08 and FY09, respectively, up from 1.6m tonnes and 2.2m tonnes previously.

COG: sales-volume forecasts (m tonnes)

Sales volume	2006	2007F	2008F	2009F
Jinxi				
Billets	1.17	0.30	0.40	0.40
Strips	2.20	2.70	2.70	2.70
H-section	0.25	1.20	1.80	2.40
Subtotal in Jinxi	3.62	4.20	4.90	5.50
Foshan Jinlan (60% stake)				
Cold-rolled (CR) steel	0.04	0.01	0.01	0.01
Galvanized sheet	0.08	0.15	0.15	0.15
Subtotal in Foshan	0.12	0.16	0.16	0.16
Total sales volume	**3.75**	**4.36**	**5.06**	**5.66**
% YoY	12	16	16	12
Previous forecast		4.25	4.85	5.45
% change in forecast		3	4	4

Source: Daiwa forecasts, Bloomberg

Sustained strong demand for H beams and billets

At the same time, we have become more bullish on ASPs for FY07 and FY08, in view of the strong year-to-date surge in prices, as well as our expectation of sustained strong demand for H beams from the construction sector, and strong downstream demand for billets, the upstream semi-steel product.

We have raised our ASP assumptions for FY07 and FY08 by 8% and 20%, respectively. We forecast the ASPs of billets and H beams to rise by 15% YoY for FY08, while we keep our moderately positive view on strips, and downstream flat-steel products, such as galvanized colour-coated steel, as we do not expect the markets for these products in FY08 to be as tight.

COG: ASP forecasts (Rmb/tonne)

	2006	2007F	2008F	2009F
ASP (ex. VAT)				
Billets	2,347	2,816	3,239	3,239
Strips	2,600	3,120	3,370	3,370
H-section	2,917	3,646	4,193	4,193
CR steel	3,578	4,651	4,884	4,884
Galvanized steel	4,959	5,207	5,467	5,467
Total ASP	**2,611**	**3,327**	**3,724**	**3,774**
Previous forecast		3,074	3,114	3,105
% change in forecast		**8**	**20**	**22**
ASP % YoY				
Billets	0	20	15	0
Strips	0	20	8	0
H-section	0	25	15	0
CR steel	0	30	5	0
Galvanized steel	0	5	5	0
Total ASP	**(5)**	**27**	**12**	**1**

Source: Company, Daiwa forecasts

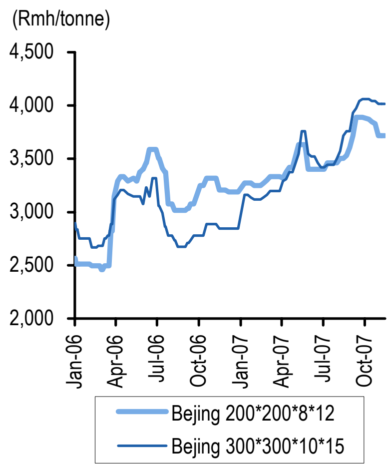
China: spot-steel prices (excluding VAT Rmb/tonne)

Rmb/tonne (excl. VAT)	Small H-section (BJ)	Large H-section (BJ)	Narrow strips (Tangshan)	Wide strips (Tianjin)	Billets (Tangshan)
1H06 average	2,934	2,950	2,535	2,699	2,369
2H06 average	3,197	2,829	2,571	2,785	2,377
FY06 average	3,065	2,889	2,553	2,742	2,373
1H07 average	3,371	3,325	2,778	2,918	2,581
2H07 YTD average	3,657	3,804	3,283	3,283	3,029
FY07 YTD average	3,514	3,564	3,030	3,101	2,805
% YoY	15	23	19	13	18

Source: Custeel

China: H-beam spot prices

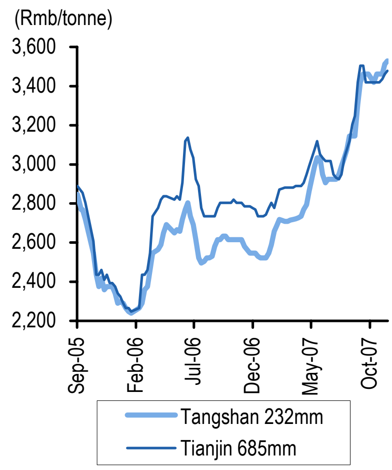
H-section Spot prices (excl. VAT)



Source: Custeel

China: strip-spot prices

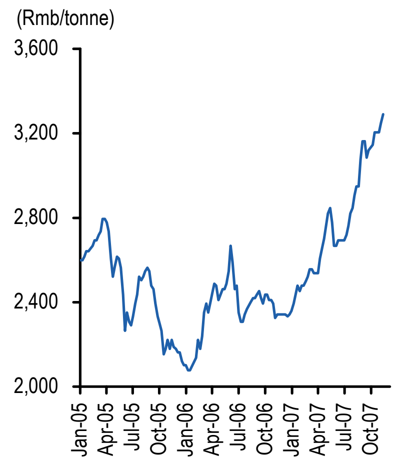
Spot prices (excl. VAT) of strips (Narrow and Mid width Strips)



Source: Custeel

China: spot-billet prices

Spot prices of billet (excl.VAT) in Tangshan



Source: Custeel

Less exposure to surging freight costs

At the same time, we have also factored the surge in raw-material costs into our forecasts. We have revised up our unit-cost-of-production forecasts by 10% and 23% for FY07 and FY08, respectively, in view of the rising iron-ore costs, coking-coal prices and fuel costs. On our estimates, COG's unit cost of production will increase by 9% YoY for FY08, but will be offset by a 12% YoY increase in the ASP for FY08. In our view, COG's proximity to domestic iron ore, coal and other feedstock supplies, mean it has less exposure to surging freight costs.

COG: unit-cost-of-production forecasts

	2006	2007F	2008F	2009F
Unit COGS (Rmb/tonne)				
Raw materials	1,778	2,312	2,543	2,543
Auxiliary materials	198	200	200	200
Energy and utilities	160	170	179	179
Depreciation	78	71	71	71
Staff costs	48	33	33	33
R&M	25	25	25	25
Total unit COGS	**2,287**	**2,811**	**3,051**	**3,051**
Previous forecast		2,556	2,476	2,379
% change in forecast		**10**	**23**	**28**
Unit COGS % YoY				
Raw materials	(9)	30	10	0
Auxiliary materials	(7)	1	0	0
Energy and utilities	15	5	5	0
Depreciation	30	(9)	0	0
Staff costs	33	(31)	0	0
R&M	(19)	1	0	0
Total unit COGS	**(4)**	**1**	**9**	**0**

Source: Company, Daiwa forecasts

Prospects rosy if AcelorMittal takes further stake

Why ArcelorMittal is interested in COG

ArcelorMittal is positive on Chinese steel demand, given that demand is being driven by urbanisation and the migration of economic development from the coastal areas to middle and western China. In view of this, acquiring one of the largest H-beam producers in the China, ie, COG, is a sensible strategy, in our view.

We forecast China's annual production of H beams, which are used mainly in construction and infrastructure, to reach 35m tonnes in FY07, with small- to medium-sized H beams accounting for 73% of the total output produced by small- to medium-sized private steel mills. Hence, this sector is very fragmented. COG produces small- to medium-sized H beams, while large-section H beams are produced mainly by the large state-owned steel mills.

We believe ArcelorMittal's move would be of concern to COG's close competitors, such as Rizhao and Laigang Steel, which are the top small- to medium-sized H-beam producers in China.

In addition, in view of the fragmented H-beam market, we think it is possible that ArcelorMittal would be interested in acquiring more H-beam producers, if conditions allow.

COG to benefit from the involvement of a top-class shareholder

If ArcelorMittal gained a controlling stake in COG, we think it would transfer its core technology in H-beams, leading to COG becoming a top-class (in terms of product quality) H-beam producer in China.

In addition, with ArcelorMittal's financial backing and top-class management, we think COG could expand into one of the largest H-beam producers in China. Moreover, ArcelorMittal's strong upstream raw-material sourcing channel would provide COG with cheaper raw-material purchases.

We believe that as a private enterprise registered in Bermuda, COG is not subject to the Chinese government's policy forbidding foreign companies from having controlling stakes in Chinese steel companies. Nevertheless, the acquisition would still be subject to the government's approval in terms of anti-trust issues.

China Oriental Group – financial summary

Profit and loss (Rmb m)

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Revenue	**9,183**	**9,782**	**14,508**	**18,846**	**21,362**
Operating expenses	(7,901)	(8,114)	(12,208)	(15,468)	(17,341)
EBITDA	**1,282**	**1,668**	**2,300**	**3,378**	**4,020**
Depreciation and amortisation	(263)	(309)	(309)	(309)	(308)
EBIT	1,019	1,359	1,991	3,068	3,712
Interest income	66	-	24	16	25
Interest expenses	(79)	(125)	(124)	(123)	(122)
Net interest income/(expenses)	(12)	(125)	(100)	(107)	(97)
Associates/JV	(2)	(1)	(1)	(1)	(1)
Profit before tax	1,004	1,233	1,890	2,961	3,614
Tax paid	(157)	(211)	(299)	(977)	(1,193)
Minorities	(1)	10	(19)	(19)	(19)
Net profit	**847**	**1,033**	**1,572**	**1,965**	**2,403**

Cash flow (Rmb m)

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Pre-tax profit	1,004	1,233	1,890	2,961	3,614
Depreciation/amortisation	208	327	411	411	411
Associate adjustment	2	1	1	1	1
Change in working capital	694	1,174	(664)	(609)	(353)
Tax paid/credited	(244)	(204)	(208)	(638)	(1,085)
Other operating	7.3	0.0	0.0	0.0	0.0
Operating cash flow	**1,672**	**2,531**	**1,431**	**2,125**	**2,588**
Capital expenditure	(854)	(587)	(1,500)	(1,500)	(1,500)
Investments	(24.)2	0.0	0.0	0.0	0.0
Asset/invest disp at selling price	4.0	8.1	0.0	0.0	0.0
Equity raised	0.0	0.0	0.0	0.0	0.0
Dividend paid	(146)	(165.8)	(132.1)	0.0	0.0
Other investment/equity	(3,743.3)	(3.0)	0.0	0.0	0.0
Net chg in cash	**(3,091.8)**	**1,784.2**	**(201.6)**	**625.5**	**1,087.9**
Free cash flow	821.9	1,952.9	(69.5)	625.5	1,087.9

Source: Company, Daiwa forecasts

Balance sheet (Rmb m)

As at 31 Dec	2005	2006	2007F	2008F	2009F
Fixed assets					
Tangible	4,346	4,792	5,874	6,955	8,037
Associates/JV	9	8	7	6	5
Others	2.3	0.0	0.0	0.0	0.0
Current assets					
Cash and equivalent	1,725	530	799	1,232	2,127
Accounts receivable/debtors	714	999	1,481	1,924	2,181
Inventories	1,103	1,408	2,088	2,712	3,074
Other current assets	253	484	717	931	1055
Current liabilities					
Current debts	1346	573	1136	1036	936
Accounts payable	632	516	766	995	1128
Others	1133	1114	1687	2469	2834
Non-current liabilities					
Long-term debt	294	361	261	161	61
Other	15	56	56	56	56
Net assets	**4,732**	**5,601**	**7,060**	**9,044**	**11,466**
Financed by:					
Share capital	2,460	2,460	2,460	2,460	2,460
Reserves	2,133	3,019	4,459	6,423	8,826
Shareholders' funds	4,593	5,479	6,919	8,884	11,286
Minority interest	139	122	141	160	179
Net assets	**4,732**	**5,601**	**7,060**	**9,044**	**11,466**
Total assets	8,153	8,221	10,966	13,760	16,479
Net debt	(85)	404	598	(35)	(1,130)

Ratios (%)

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Operating margin	11.8	13.1	13.6	16.1	17.2
A/C receivable turnover (days)	28.4	37.3	37.3	37.3	37.3
EBITDA margin	14.0	17.1	15.9	17.9	18.8
Net debt to equity	Net cash	4.5	6.4	Net cash	Net cash
EBITDA/gross interest expenses (x)	16.3	13.4	18.6	27.5	33.1
ROE	18.4	18.8	22.7	22.1	21.3
Dividend payout	16.1	16.1	16.1	16.1	16.1
ROA	10.4	12.6	14.3	14.3	14.6

Daiwa forex assumptions (vs. US$)

Year end	Rmb	HK$	W	S$	NT$	A$	Bt
2005	8.070	7.800	1,013.0	1.664	32.850	1.363	41.030
2006	7.810	7.800	929.6	1.534	32.596	1.264	36.045
2007F	7.150	7.800	900.0	1.480	32.700	1.176	33.500
2008F	6.500	7.800	875.0	1.430	32.200	1.170	31.650
2009F	6.000	7.800	882.0	1.400	31.900	1.190	30.800

Source: Daiwa

Note: The investment indicators and income summary on the front page of this report, as well as the above financial summary are all based on the forex assumptions set out in this table, unless stated otherwise.

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