

China Oriental

Raise PT on acquisitions

- We raise our price target by 73% to HK\$8 on the ArcelorMittal take-over. We maintain OW on China Oriental.
- **Investment drivers:** ArcelorMittal made a general offer for China Oriental's shares in the range of HK\$6.36-HK\$6.83/share, implying 10.4x-11.2x FY08E P/E. This is very positive for China Oriental's share price, in our view. ArcelorMittal currently owns 28% of China Oriental and eventually will have 75% of its shares. This will be the first time a foreign steel maker gains a foothold in China through acquisition, assuming the acquisition is successful. The acquisition will need to meet the Chinese government's Anti-trust conditions, and might take 30-90 days to approve.
- **Catalysts, share price drivers:** We expect steel prices to rise in 2008. ArcelorMittal would help China Oriental cut raw material procurement costs by turning from the spot market to contracts. In November, China's crude steel production was only up by 4.6% Y/Y, much lower than the apparent consumption growth of 10%. We expect China's steel demand growth to continue to outpace supply growth, leading to strong steel prices in 2008.
- **Price target, valuation, key risks:** We derive our Dec 08 price target of HK\$8/share by applying 11.6x P/E to FY08E EPS of Rmb/share (Dec. 08 exchange rate of Rmb6.6/US\$). The key risk to our rating and price target is failure of the acquisition. .

Reuters: 0581.HK, Bloomberg: 581

Rmb in millions, year-end December

	2003	2004	2005	2006	2007E	2008E	52-Week Range	1.77 - 6.44
Sales	5,278	9,119	9,183	9,782	13,669	16,333	Mkt cap (HK\$ mm)	18,849
NP	1,076	1,173	847	1,033	1,429	1,700	Mkt cap (US\$ mm)	2419
EPS(Rmb)	0.51	0.42	0.29	0.36	0.49	0.58	Free float	26%
EPS(Y/Y)	177%	-17%	-31%	22%	37%		AVG daily value (HK\$ MM)	25.8
BPS(Rmb)	0.45	1.40	1.58	1.89	2.27	2.74	AVG daily value (US\$ MM)	3.3
DPS(Rmb)	0.23	0.23	0.05	0.07	0.09	0.11	AVG daily volume	5.3 mm
P/E	11.9	14.4	21.0	17.2	12.5	10.5	Shares outstanding(mm)	2,927
P/B	13.6	4.4	3.9	3.2	2.7	2.2	MSCI China	88
EV/EBITDA	10.8	12.1	13.4	11.5	8.1	6.1	HK\$/US\$	7.79
Dividend Yield	4%	4%	1%	1%	1%	2%		
ROE	168%	49%	20%	21%	24%	23%		
Net debt/equity	90%	-27%	-2%	7%	2%	-11%		
Performance				1mth	3mths	12 mths		
Absolute (%)				19.3	69.0	261.8		
Relative to MSCI China(%)				16.4	52.2	169.2		

Source: Company data, Datastream, JPMorgan estimates.

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Overweight

HK\$6.44

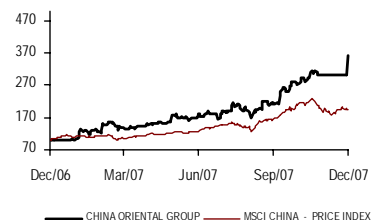
13 December 2007
Price Target: HK\$8.00

Hong Kong
Steel

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One-year relative performance



Source: Datastream

General offer

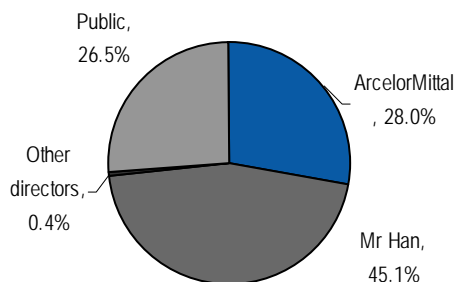
ArcelorMittal made a general offer for China Oriental's shares in a price range of HK\$6.36-HK\$6.83/share, at which investors have the option to sell their shares to ArcelorMittal.

On November 9 2007, ArcelorMittal and China Oriental's largest shareholder, Mr. Han, entered into a shareholders' agreement, including two call options that allow ArcelorMittal to acquire shares from Mr. Han and one put option that allows Mr. Han to sell its shares to ArcelorMittal.

ArcelorMittal currently owns 28% of China Oriental's shares and is the second-largest shareholder, after it bought shares from Smart Triumph Corporation.

Mr. Han holds 45%, public investors hold 26%, and directors of the company hold 0.4%.

Figure 1: Shareholding structure



Source: Company

Earnings to grow in FY08E

We fine-tune our model and cut FY07E EPS by 5% and FY08E EPS by about 3%. We expect FY08 EPS to grow by about 18% Y/Y on 10% volume growth and improving margins. Margins are likely to improve on cheaper raw material procurement costs and product mix improvement.

ArcelorMittal said in the statement that it would "source a fixed minimum quantity of iron ore per annum to be sold to China Oriental, and provide assistance in the sourcing of coking coal". ArcelorMittal will also "provide certain technologies, technical expertise, mergers and acquisitions expertise, financial and funds management expertise and assistance in exploring overseas marketing opportunities", for so long as ArcelorMittal has 25% or more of the issued shares in China Oriental.

Product mix is improving mainly as a result of H-beam production increases. H beam is a product used in construction with higher selling prices and margins.

Table 1: What has changed

	2007E			2008E		
	Old	New	Change	Old	New	Change
Volume sales('000 tons)						
Billets	74	208	180%	65	154	137%
Narrow width strip	1,500	1,450	-3%	1,600	1,450	-9%
Mid width strip	1,300	1,300	0%	1,400	1,350	-4%
H beam	1,000	1,250	25%	1,000	1,600	60%
CRC & Gal	200	200	0%	300	300	0%
Total	4,074	4,408	8%	4,365	4,854	11%
ASP (Rmb/t)						
Billets	2,460	2,550	4%	2,765	2,800	1%
Narrow width strip	2,685	2,738	2%	2,975	2,975	0%
Mid width strip	3,060	3,000	-2%	3,325	3,220	-3%
H beam	3,510	3,450	-2%	3,745	3,640	-3%
CRC	4,185	4,125	-1%	4,375	4,270	-2%
ASP	3,102	3,101	0%	3,369	3,365	0%
Cost						
Iron ore (Rmb/t)	788	943	20%	840	995	18%
Coke (Rmb/t)	1,118	1,144	2%	1,095	1,164	6%
COGS per ton	2,607	2,657	2%	2,796	2,846	2%
EPS(Rmb/share)	0.52	0.49	-5%	0.60	0.58	-3%

Source: JPMorgan estimates

Table 2: Major assumptions

	2003	2004	2,005	2006E	2007E	2008E
ASP(Rmb/t)	2,180	2,694	2,753	2,611	3,101	3,365
		24%	2%	-5%	19%	8%
CRC (Rmb/t)			3,826	3,578	4,125	4,270
				-6%	15%	4%
Volume sales('000 tons)	2,421	3,385	3,336	3,746	4,408	4,854
		40%	-1%	12%	18%	10%
COGS(Rmb/t)	1,671	2,307	2,386	2,231	2,657	2,846
		38%	3%	-6%	19%	7%
Margin(Rmb/t)	509	387	367	380	445	519
		-24%	-5%	4%	17%	17%
Iron ore(Rmb/t)	418	710	735	755	943	995
		70%	3%	3%	25%	5%
Coking coal(Rmb/t)	809	1,055	1,107	1,053	1,144	1,164
		30%	5%	-5%	9%	2%

Source: Company data, JPMorgan estimates.

Price target raised to HK\$8/share

We raise our price target to HK\$8/share and stay OW on the stock. China Oriental has been trading at a large discount to domestic and global peers. With ArcelorMittal taking the controlling stake, the discount should disappear, in our opinion.

We derive our Dec-08 price target of HK\$8/share by applying 11.6x P/E to FY08E EPS of Rmb0.58/share. 11.6x P/E is the global steel comp average.

Table 3: Steel comps

	EV/ EBITDA			P/E		
	2006	2007E	2008E	2006	2007E	2008E
AK Steel	13.8	6.2	5.9	51.7	13.3	11.6
Angang New Steel	10.5	7.9	6.0	17.8	15.7	12.9
ArcelorMittal	8.7	6.8	6.5	13.0	10.4	9.6
Baoshan Iron & Steel	10.6	9.0	6.9	21.3	17.8	12.6
Barrick Gold	14.5	13.9	7.9	25.9	32.0	15.8
BlueScope Steel	7.5	6.4	7.1	12.3	11.2	13.6
China Oriental Group Companies	11.5	8.1	6.1	17.2	12.5	10.5
Maanshan Iron and Steel	10.1	8.3	4.6	14.3	16.1	8.9
OneSteel	10.7	7.3	5.0	19.5	16.6	12.6
Steel Dynamics	8.1	7.3	6.6	14.7	13.0	11.3
US Steel Corp	6.3	7.2	5.9	10.3	11.7	10.6
China Steel	NA	NA	NA	12.0	9.5	9.2
POSCO	9.2	7.9	7.3	15.3	12.7	12.5
Average	10.0	8.0	6.3	18.7	14.6	11.6
Weighted average	9.9	7.9	6.5	16.9	14.8	11.6

Source: JPMorgan estimates. Prices as of 12 Dec 2007. China Oriental priced as of 13 Dec.

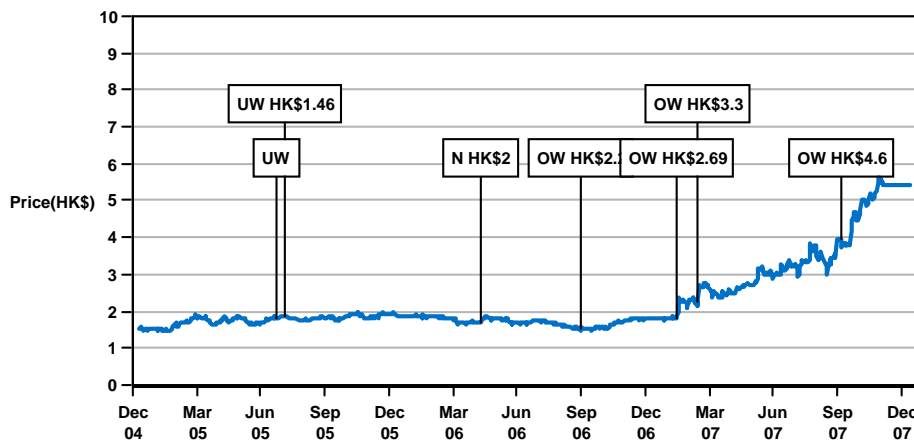
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China Oriental (0581.HK) Price Chart



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	2.25	3.30
06-Sep-07	OW	3.93	4.60

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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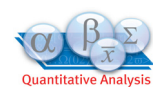
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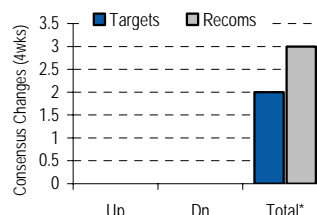
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All Data As Of 12-Dec-07

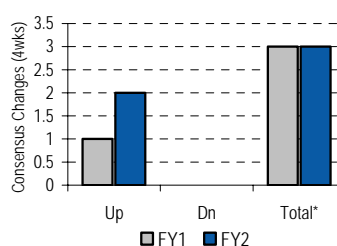
Q-Snapshot: China Oriental Group Co. Ltd.



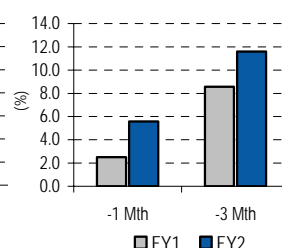
Targets & Recommendations



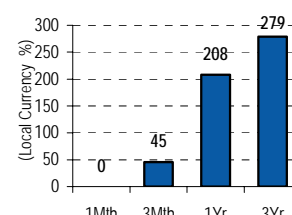
EPS Revisions



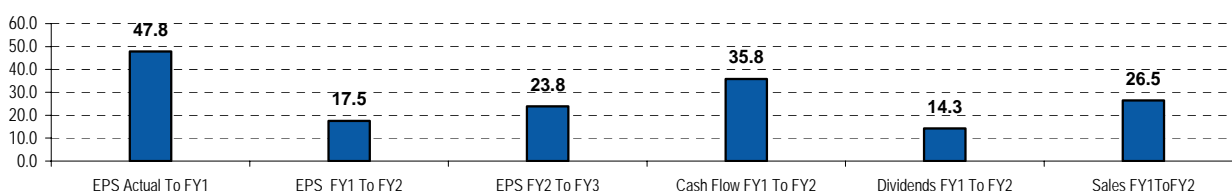
EPS Momentum (%)



Historical Total Return (%)



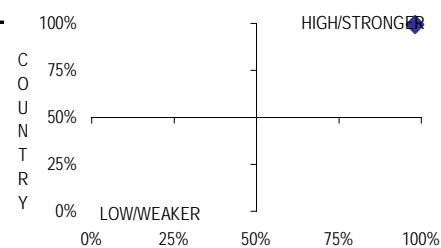
Consensus Growth Outlook (%)



Quant Return Drivers (A Score >50% indicates company ranks 'above average')

Score 0% (worst) to 100% (best)	vs Country Peers	vs (regional) IBES Industry Peers
Valuations: P/E Vs Market (12mth fwd EPS)	60%	81%
Valuations: P/E Vs Sector (12mth fwd EPS)	57%	79%
Valuations: EPS Growth (forecast)	72%	72%
Momentum: 12 Month Price Momentum	93%	82%
Momentum: 1 Month Price Reversion	35%	51%
Quality: Return On Equity (forecast)	69%	63%
Quality: Earnings Risk (Variation in Consensus)	96%	90%
Earnings&Sentiment: Earnings Momentum	91%	87%
Earnings&Sentiment: Change in Recoms	99%	97%
Earnings&Sentiment: Net Revisions Fy2 EPS	83%	97%

JPMorgan Composite Q-Score



COMPOSITE Q-SCORE** (0% To 100%)

99% vs Country Peers, 98% vs (regional) IBES Industry Peers

Regional IBES Industry Peers (Closest by Size, Consensus. ADV = Average daily value traded in US\$m over the last 3 mths)

Code	Name	Country	USD MCAP	ADV	PE FY1	Q-Score**
5444-JP	Yamato Kogyo Co. Ltd.	Japan	3,072	25.42	10.7	77%
MRE-AU	Minara Resources Ltd.	Australia	2,963	14.35	10.4	37%
600001-CN	Handan Iron & Steel Co. Ltd.	China	2,935	58.59	18.6	60%
600357-CN	Chengde Xinxin Vanadium & Titanium Co. Ltd	China	2,372	55.96	30.8	
5541-JP	Pacific Metals Co. Ltd.	Japan	2,060	96.25	6.1	81%
581-HK	China Oriental Group Co. Ltd.	China	2,014	1.56	9.6	98%
600072-CN	CSSC Jiangnan Heavy Industry Co. Ltd.	China	1,919	59.06	153.3	27%
000778-CN	Xinxing Ductile Iron Pipes Co. Ltd.	China	1,908	24.76	21.7	
532144-IN	Welspun Gujarat Stahl Rohren Ltd.	India	1,690	8.63	28.5	66%
9962-JP	Misumi Group Inc.	Japan	1,568	11.32	17.5	20%
000831-CN	Shanxi Guanlu Co. Ltd.	China	1,511	37.92	39.3	86%

Country Peers (Closest by Size, Consensus. ADV = average daily value traded in US\$m over the last 3 mths)

Code	Name	Industry	USD MCAP	ADV	PE FY1	Q-Score**
303-HK	VTECH Holdings Ltd.	Telecommunications Equipment	2,077	5.68	9.8	88%
588-HK	Beijing North Star Co. Ltd.	Real Estate Development	2,073	9.36	26.0	13%
506-HK	China Foods Ltd.	Food: Specialty/Candy	2,059	6.49	31.4	13%
2880-HK	Dalian Port (PDA) Co. Ltd.	Other Transportation	2,049	5.00	22.2	9%
1888-HK	Kingboard Laminates Holdings Ltd.	Industrial Specialties	2,047	2.98	8.7	76%
581-HK	China Oriental Group Co. Ltd.	Steel	2,014	1.56	9.6	99%
179-HK	Johnson Electric Holdings Ltd.	Miscellaneous Manufacturing	2,006	3.61	14.8	27%
152-HK	Shenzhen International Holdings Ltd.	Air Freight/Couriers	1,988	24.70	8.3	99%
3308-HK	Golden Eagle Retail Group Ltd.	Department Stores	1,978	3.35	44.4	44%
696-HK	TravelSky Technology Ltd.	Miscellaneous Commercial Services	1,936	2.80	24.3	48%
3339-HK	China Infrastructure Machinery Holdings Ltd.	Trucks/Construction/Farm Machinery	1,930	8.06	20.8	78%

Source: Factset, Thomson and JPMorgan Quantitative Research. For an explanation of the Q-Snapshot, please visit <http://jpmorgan.hk.acrobat.com/qsnapshot/>
Q-Snapshots are a product of JPMorgan's Global Quantitative Analysis team and provide quantitative metrics summarized in an overall company 'Q-Score.'

Q-Snapshots are based on consensus data and should not be considered as having a direct relationship with the JPMorgan analysts' recommendation.

* Total number of target prices, recommendations or EPS forecasts that make up consensus. ** The Composite Q-Score is calculated by weighting and combining the 10 Quant return drivers shown. The higher the Q-Score the higher the one month expected return. On a 14 Year back-test the stocks with the highest Q-Scores have been shown (on average) to significantly outperform those stocks with the lowest Q-Scores in this universe.

China Oriental Group: Summary of financials

Rs in millions, year-end December

Profit and loss statement

CNY in millions, year-end Dec	FY04A	FY05A	FY06	FY07E	FY08E
Revenues	9,119	9,183	9,782	13,669	16,333
% change Y/Y	72.8	0.7	6.5	39.7	19.5
Gross margin (%)	14.4	13.3	14.6	14.3	15.4
EBITDA	1,378	1,315	1,580	2,207	2,766
% change Y/Y	9.1	-4.6	20.2	39.7	25.3
EBITDA margin (%)	15.1	14.3	16.2	16.1	16.9
EBIT	1,229	1,018	1,266	1,773	2,294
% change Y/Y	5.3	-17.1	24.3	40.1	29.4
EBIT margin (%)	13.5	11.1	12.9	13.0	14.0
Net interest	-64	-12	-31	-50	-50
Earnings before tax	1,171	1,004	1,233	1,722	2,243
% change Y/Y	2.5	-14.3	22.8	39.6	30.3
Tax	30	157	211	294	561
as % of EBT	2.6	-15.6	-17.1	-17.1	-25.0
Net income (reported)	1,173	847	1,033	1,429	1,700
% change Y/Y	9.0	-27.8	22.0	38.4	19.0
Shares outstanding (MM)	2770	2905	2905	2927	2927
EPS (reported) (CNY)	0.424	0.291	0.355	0.488	0.581
% change Y/Y	-17.4	-31.2	22.0	37.3	19.0

Cash flow statement

CNY in millions, year-end Dec	FY04A	FY05A	FY06	FY07E	FY08E
EBIT	1,229	1,018	1,266	1,773	2,294
Depreciation & amortization	150	297	315	434	472
Change in working capital	-469	269	-966	-798	-383
Taxes	30	-157	-211	-294	-561
Cash flow from operations	393	620	381	1,065	1,789
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	565	1,289
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	-265	-265
Beginning cash	153	2,925	1,725	530	830
Ending cash	2,925	1,725	530	830	1,854
DPS (CNY)	0.226	0.047	0.066	0.091	0.108

Balance sheet

CNY in millions, year-end Dec	FY04A	FY05A	FY06	FY07E	FY08E
Cash and cash equivalents	2,925	1,725	530	830	1,854
Accounts receivable	828	714	999	1,396	1,668
Inventories	900	1,103	1,408	1,972	2,327
Others	412	253	484	677	809
Current assets	5,065	3,796	3,421	4,876	6,658
Long-term investments	0	0	0	0	0
Net fixed assets	2,349	4,236	4,675	4,587	4,615
Total assets	7,482	8,153	8,221	9,977	11,726
Liabilities					
Short-term loans	1,420	1,336	573	573	573
Payables					
Others	1,577	1,929	1,802	2,118	2,469
Total current liabilities	2,997	3,112	2,203	2,852	3,235
Long-term debt	459	294	361	361	361
Other liabilities	25	15	56	0	0
Total liabilities	3,481	3,421	2,620	3,213	3,595
Shareholders' equity	3,885	4,593	5,479	6,641	8,008
BVPS (CNY)	1.403	1.581	1.886	2.269	2.736

Ratio analysis

%, year-end Dec	FY04A	FY05A	FY06	FY07E	FY08E
EBITDA margin	15.1	14.3	16.2	16.1	16.9
Operating margin	13.5	11.1	12.9	13.0	14.0
Net profit margin	12.9	9.2	10.6	10.5	10.4
SG&A/sales	15.1	14.3	16.2	16.1	16.9
Sales per share growth	72.8	0.7	6.5	39.7	19.5
Sales growth	72.8	0.7	6.5	39.7	19.5
Net profit growth	9.0	-27.8	22.0	38.4	19.0
EPS growth	-17.4	-31.2	22.0	37.3	19.0
Interest coverage (x)	21.4	113.4	50.2	43.8	54.9
Net debt to total capital	-14.2	-1.2	5.0	1.1	-7.9
Net debt to equity	-26.9	-2.1	7.4	1.6	-11.5
Sales/assets	173.0	117.5	119.5	150.2	150.5
Assets/equity	192.6	177.5	150.0	150.2	146.4
ROE	48.6	20.0	20.5	23.6	23.2
ROCE	31.9	17.0	20.0	25.3	27.8

Source: Company and JPMorgan estimates.