China Oriental Group (581 HK)

Rating: **1**

FY07 results miss forecasts, but prospects promising

Materials: China
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Target price: **HK$7.25** (+20.6%)
Share price: HK$6.01 (Suspended)

Reuters code		0581.HK

Market data

HSI		22,664.22
Market cap	(US$bn)	2.26
EV	(US$bn; 08F)	2.1
3-mth avg daily T/O	(US$m)	3.15
Shares outstanding	(m)	2,929
Free float	(%)	27.1
Major shareholder		Wellbeing Holdings Ltd. (42.8%)
Exchange rate	Rmb/US$	7.012
	HK$/US$	7.779

Performance (%)*	1M	3M	6M
Absolute	0.0	(5.4)	29.8
Relative	8.0	16.3	55.0

Source: Daiwa
Note: *Relative to HSI

Investment indicators

PER	(x; 08F)	7.6
	(x; 09F)	5.9
PCFR	(x; 08F)	7.4
	(x; 09F)	5.5
EV/EBITDA	(x; 08F)	4.5
	(x; 09F)	3.9
PBR	(x; 08F)	1.6
	(x; 09F)	1.2
Dividend yield	(%; 08F)	2.2
	(%; 09F)	2.8
ROE	(%; 08F)	25.5
ROA	(%; 08F)	16.0
Net debt equity	(%; 08F)	4.3

Source: Daiwa forecasts

Income summary (Rmb m)

Yr to 31 Dec	2007	2008F	2009F
Revenue	13,498.6	19,396.5	21,912.4
YoY (%)	38.0	43.7	13.0
EBITDA	1,870.7	3,288.8	3,857.1
YoY (%)	13.4	75.8	17.3
Net profit	1,159.7	1,905.3	2,291.2
YoY (%)	12.3	64.3	20.3
EPS (Rmb)	0.396	0.650	0.782
YoY (%)	11.4	64.2	20.3
CFPS (Rmb)	0.396	0.676	0.844
DPS (Rmb)	0.105	0.109	0.131

Source: Company, Daiwa forecasts

Investment summary

On the back of a 38% YoY increase in revenue, China Oriental Group (COG) recorded a 12% YoY increase in net profit to Rmb1,160m for FY07, 26% and 19% below our and the market's forecasts, respectively. Stripping out the non-recurrent item (the granting of share options), our over-estimation of earnings resulted from our over-estimation of sales volume and slight underestimation of unit cost of production. We were impressed with the strong margin expansion in its H-section steel segment, with its future aggressive expansion plans, which should further boost earnings and its leading position in the H-section market. We reiterate our **1** (*Buy*) rating and have a six-month target price of HK$7.25 (based on a 9x PER on our FY08 EPS forecast). We will issue an update shortly. The stock remains suspended until ArcelorMittal and COG have finalised how to retain its listing status. For the first time, management appears confident that the PRC Government would approve ArcelorMittal's acquisition of COG.

Fundamentals

- **Aggressive expansion plans.** By 2008, COG guides for its own production to reach 6m tpa, as its 1.2m-tpa H-section line is scheduled to come on stream in 2H08. By 2009, it plans to have developed into a 10m-tpa big steel plant, on the back of domestic M&As. Industry consolidation amid current rising costs has resulted in the closing down of many small steel plants in the Tamgshan area. Private steel plants with production capacities of around 2m tpa with a focus on upstream production are COG's primary targets. Beyond 2009 and with the help of ArcelorMittal, COG believes it can expand into a 20-30m-tpa steel plant, but has not disclosed the source of funding for the great leap forward.

- **Strong upside potential for technology updates and competitiveness.** Management is sanguine about its world-class H-section production facilities, and believes that full product specification, including both large and small-section steel, also adds to its competitiveness as one of the three largest H-section producers in China. In the future, with the help of technology transfer from ArcelorMittal, the company expects to strengthen its competitiveness in H-section production.

- **Cost competitiveness.** Other than its proximity to raw-material supplies, COG's economies of scale, improved product mix (the commissioning of the second H-section line in 2H08, and high-margin H-section (margin of 19% for FY07 versus 10% for FY06) will contribute 50% of total revenue by 2009), will help cushion the company from rising cost pressure, in our view.

COG: earnings summary

	1H07	2H07	2H07 F	% YoY	% var.
Sales volume (m tonnes)	2.19	1.94	2.17	(11.7)	(11)
ASP (Rmb/tonne)	3,033	3,556	3,625	17.3	(2)
Revenue (Rmb m)	6,648	6,884	7,860	3.5	(12)
Cost of production (Rmb m)	5,559	6,045	6,697	8.7	(10)
Unit cost of production (Rmb/tonne)	2,536	3,122	3,089	23.1	1
SG&A expenses	114	307	191	169.8	60
Net profit (Rmb m)	769	391	803	(49.2)	(51)
EPS (Rmb)	0.265	0.132	0.272	(50.3)	
Gross margin (%)	16.4	12.1	14.8		
Net-profit margin (%)	11.6	5.7	10.2		

Source: Company, Daiwa

COG: earnings summary

	2006	2007	2007F	% YoY	% var.
Sales volume (tonnes)	3.75	4.13	4.36	*10.2*	(5)
ASP (Rmb/tonne)	2602	3265	3,327	*25.5*	(2)
Revenue (Rmb m)	9,782	13,499	14,508	*38.0*	(7)
Cost of production (Rmb m)	*8,358*	*11,581*	12,255	*38.6*	(5)
Unit cost of sales (Rmb/tonne)	2,222	2,801	2,811	*26.1*	0
SG&A expenses	184	420	305	*128.9*	38
Net profit (Rmb m)	1033	1160	1,572	*12.3*	(26)
EPS (Rmb)	0.356	0.396	0.537	11.4	(26)
Gross margin (%)	14.6	14.2	15.5		
Net margin (%)	10.6	8.6	10.8		

Source: Company, Daiwa

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