



China Oriental Group

(中國東方集團)

Undervalued leader

Equity Research

Steel / China

BUY

TP: HK\$3.50
(+50%, 6 mths horizon)

Price: HK\$2.34

HKEx Code: 581

Tue, 10 Aug 2010

China Oriental (“CO”) is the second largest private steel maker in China with 11mn tons of capacity. It is the No.1 maker of H-section steel in China with 28.5% market share. H-section steel is used mainly in high-rise commercial buildings and infrastructure projects, which are not affected by government’s policies to cool the residential property market. ArcelorMittal (“AM”), the world’s largest steel maker, is the second largest shareholder of CO with 29.6%. AM is actively involved in CO’s operation in management and technology support. CO is a highly efficient steel maker with the third highest productivity per employee ratio in the industry. Its 1H10 net profit increased by 122% yoy to 790mn, driven by volume growth and margin improvement of H-section steel. Recommend BUY, with a TP of HK\$3.50, based on 7x FY10E PE, at 50% discount to peer average to allow for poor liquidity, offering 50% upside.

Strong 1H10 results

- 1H10 revenue +67% yoy to RMB15,350mn, net profit +122% yoy to RMB798mn, enabled by capacity expansion (+57%) and gross margin improvement from 8% to 9%, mainly driven by significant gross margin expansion of the H-section steel (from 4.3% to 11.8%).

Second largest private steel maker in China

- Located in Hebei. The only non-state-owned large scale steel maker listed in Hong Kong.
- Current production capacity of 11mn tons, up 57% from last year. Above the 10mn tons minimum level required by government, so is able to consolidate smaller players. Intends to increase capacity up to 15mn in 2015, through acquisition and organic growth.
- Highly efficient: Ranked No.3 in terms of employee productivity in 2009, with 669tons/person vs industry average of 247tons/person. As such, it was able to generate RMB884mn net profit in FY09 (18% higher than Angang’s RMB752mn although the latter’s revenue was 3.4x times that of CO.)

Largest maker of H-section steel in China

- No.1 maker with 28.5% market share. H-section steel accounted for 27% of production capacity currently and 34% revenue in 1H10. Plans to have H-section steel to account for 50% of capacity in the medium term.
- H-section steel is widely used in high rise buildings and infrastructure projects. CO’s H-section steel was used in land-mark buildings such as the Olympic Stadium Bird’s Nest, Water Tube and CCTV Tower.
- As such is not affected by the government policies to tighten the residential property market.

Support from AcerlorMittal

- ArcerlorMittal is the world’s largest steel maker and a leader in H-section steel production and innovation.
- AM has appointed 3 board members, including 1 executive director and 2 non-executives. The ED also acts as Deputy General Manager and a member of the Management Committee, participating in the day-to-day operation of CO.
- AM has 2 teams of engineers working in CO to share best practice on production and quality control.

Low valuation and solid balance sheet

- Bloomberg consensus: Trading at 5.5x FY10E PE, vs peer average of 13.7x; At 0.77x 1H10 PB vs peer average of 0.98x FY10E PB.
- Healthy balance sheet, with 14.6% net gearing ratio.

Recommendation

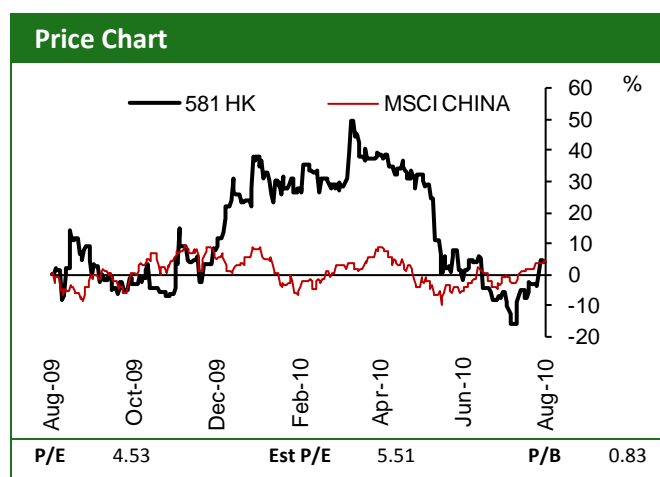
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Company Background

The Group is principally engaged in the production and sales of billets and strips.

Key Data	
Close Price (HK\$)	2.34
12 Month High (HK\$)	3.50
12 Month Low (HK\$)	1.80
3M Avg Daily Vol. (mn)	0.28
Issue Shares (mn)	2,929.73
Market Cap (HK\$ mn)	6,855.56
Free Float (%)	25.01
Net cash/share (HK\$)	0.98
Net debt/ equity (%)	38.67
Fiscal Year	12/2009
Major Shareholder(s)	Wellbeing Holdings (42.9%)

*Source: Company data, Bloomberg, OP Research
Closing prices are as of 9/8/2010
All figures are subject to rounding*



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Hold (H)	We expect this stock to perform in line with the relevant benchmark over the next 12 months.
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Relevant Benchmark	Represents the stock closing price as at the date quoted in this report.

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