

Analyst: Sam Ho

## Main Board Listing- Research

中國東方集團控股有限公司

China Oriental Group Company Limited - [Stock Code: 0581]
**Joint Global Coordinators and Joint Bookrunners** : Merrill Lynch & Co. JPMorgan

**Joint Sponsors** : Merrill Lynch Far East Limited JPMorgan

**Sector** : Mining

**Business**: Production and sale of billets and strips in China

<p><b>Total share offer:</b> <u>700,000,000</u> shares (25% of the enlarged share capital)</p> <p><b>Placement:</b> 630,000,000 shares (90%) <b>IPO:</b> 70,000,000 shares (10%)</p> <p><b>Greenshoe:</b> 105,000,000 shares</p> <p><b>Price:</b> HK\$2.10-HK\$2.75 per share <b>Market cap. :</b> HK\$5,880 million - HK\$7,700 million</p> <p><b>Staffing:</b> 4,464</p> <p><b>Prospective 2003 P/E:</b> 6.3x-8.2x (fully diluted) <b>Adjusted NAV per share:</b> HK\$0.59-HK\$0.75</p> <p><b>IPO commences:</b> 18<sup>th</sup> February 2004 <b>IPO ends:</b> 23<sup>rd</sup> February 2004</p> <p><b>Share registrar:</b> Tricor Investor Services Limited <b>Receiving bank:</b> Hang Seng Bank</p> <p><b>Listing date:</b> 2<sup>nd</sup> March 2004</p>	<p><b><u>Business of China Oriental Group</u></b></p> <p>The Group is a steel manufacturer principally engaged in the production and sales of billets and strips in China. The Group is currently one of China's largest suppliers of billets. For the 9 months ended September 2003, it sold some 1.142 million tonnes of billets to the mainland market.</p> <p>Its customers are downstream steel manufacturers, who further process the billets and strips into downstream steel products such as angles, rebars, wire rods and pipes. These products are largely used in the construction industry and for the manufacture of machinery.</p> <p>The Group conducts its production activities at a single production site in Qianxi county, Hebei province. Its steel production facilities consist of a sintering/ pelletizing plant, an iron smelting plant, a steel-making plant and a steel-rolling plant. The whole plant is capable to produce 3.1 million tonnes of steel products per year.</p>
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### Major Shareholders after Listing

(Assuming the over-allotment option is not exercised)

Han Jingyuan, chairman and CEO of the Group (age: 47)	28.52%
Chen Ningning, vice chairman of the Group (age: 33)	14.60%
Lu Hui, a non-executive director of Jinxi Limited, which is the Group's subsidiary	14.60%
A group of employees of the Group	8.56%
Shen Xiaoling, an executive director of the Group	2.25%
Zhu Ziji, an executive director of the Group	1.40%
Zhu Jun, an executive director of the Group	1.24%
Wang Shujun, a senior management of the Group	1.24%
Zhao Jianzhu, a senior management of the Group	1.19%
Xu Zhiping, a senior management of the Group	1.08%
Huo Hongxiang, a senior management of the Group	0.18%
Zhao Zhenyong, a senior management of the Group	0.14%
	<u>75.00%</u>

### Use of Proceeds

Net proceeds from the offer are estimated to be HK\$1,600.2 million.

(Assuming the over-allotment option is not exercised and at an issue price of HK\$2.425, which is the mid-point of the indicative price range)

	HK\$ million
To fund the Group's capex programme	1,226
To serve as general corporate purses, including funding for working capital, repayment of loans as well as potential acquisitions and strategic investments in the steel industry in China	Balance

### Financial Highlights

	9 months ended 30 <sup>th</sup> September 2003 RMB'000	2002 RMB'000	2001 RMB'000	2000 RMB'000
Revenue				
<i>Billets</i>	2,282,720	1,550,755	869,513	804,061
<i>Strips</i>	1,128,945	1,023,678	621,898	70,073
<i>Others</i>	18,474	13,121	6,666	2,980
Less: taxes	(39)	(16,250)	(7,745)	(5,854)
	<u>3,430,100</u>	<u>2,571,304</u>	<u>1,490,332</u>	<u>871,260</u>
Operating profit	<u>883,624</u>	<u>604,149</u>	<u>245,029</u>	<u>181,150</u>
Net profit	<u>820,438</u>	<u>388,020</u>	<u>154,281</u>	<u>112,720</u>
Dividend	468,669 *	369,863	179,328	-
EPS- basic	<u>RMB0.39</u>	<u>RMB0.18</u>	<u>RMB0.07</u>	<u>RMB0.05</u>

\* - the Group declared a special dividend of RMB400 million in favour of its existing shareholders in January 2004

### Selected operating data

	9 months ended 30 <sup>th</sup> September 2003		FY2002		FY2001		FY2000	
<b>Sales volume</b>	'000 tonnes	%	'000 tonnes	%	'000 tonnes	%	'000 tonnes	%
Billets	1,142.4	68.8	954.4	62.8	547.4	61.3	497.7	93.9
Strips	518.5	31.2	566.4	37.2	346.2	38.7	32.2	6.1

	9 months ended 30 <sup>th</sup> September 2003	FY2002	FY2001	FY2000
Average selling price	RMB per tonne	RMB per tonne	RMB per tonne	RMB per tonne
Billets	1,988.2	1,624.9	1,588.6	1,615.5
Strips	2,177.2	1,807.2	1,796.3	2,178.6

### **Strengths**

- ✓ The Group is among the most-efficient and lowest-cost steel manufacturers in China. Its cost of production in 2001 averaged RMB1,310 per tonne of steel, lower than the national average of RMB1,624 amongst 17 other major Chinese producers.
- ✓ The Group has a broad customer base. In the 9 months ended 30<sup>th</sup> September 2003, its 5 largest customers accounted for less than 30% of its total turnover. Over the same period, its biggest customer accounted for some 6.6% of turnover. In addition, it has entered into long-term supply contracts with 4 of its 10 largest customers for billets.
- ✓ The Group is currently at the high-growth phase as over the 3 years ended 31<sup>st</sup> December 2002, its profit after tax grew at a CAGR of 85.5%. At present, over 60% of the Group's output comprises lower-priced billets. It plans to diversify into some higher-margin products, including mid-width steel strips and H-section steel in the next 2 years. With its plan to expand capacity and its target to diversify into higher-margin products, its growth momentum should be sustained in the near term.
- ✓ The Group is established from a management buy-out of an old state-owned miner. The management of the Group together with over 1,800 staff owned 75% of the outstanding shares after listing. The interests of the management should highly align with other shareholders.
- ✓ Based on the pricing range, China Oriental Group is selling its share at 2003E P/E of 6.3x-8.2x, which is undemanding when compared with other listed peers. Angang Newsteel (*stock code: 0437*) was trading at 2003E P/E of 10.4x, while Maanshan Iron & Steel (*stock code: 0323*) and Chongqing Iron & Steel (*stock code: 1053*) were trading at 2003E P/E of 8.2x and 5.7x respectively.

### **Weaknesses**

- × Competition in the steel industry is intensified as many existing and new steel companies invest in new equipment and technology as well as undertake capacity-expansion projects. Moreover, the profitability of China's steel industry so far may attract more steel imports from the international markets. Such increased competition from imports may further reduce the margins of domestic players. Meanwhile, the central government has been trying to cool over-investment in the steel sector, particularly in the low-end segments crowded with many small producers. This should be positive to established and sizeable players such as China Oriental Group.
- × Although the Group has entered into a number of long-term supply contracts with some local iron-ore suppliers, these contracts only provide it with limited certainty as to the continuity of supply because the price of iron ore for each of its orders under these contracts will fluctuate according to the prevailing market price. Increases in raw-material costs will erode its profit margin.
- × The Group plans to distribute only about 20% of its future net profits as dividends, despite an average payout of over 50% over the past 3 years. The figure compares unfavourably to estimated payouts of some 40% for Angang Newsteel, 45% for Maanshan Iron & Steel and 20.5% for Chongqing Iron & Steel.

### **Recommendation: Trading Buy**