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HONG KONG RESEARCH**9th May 2005**

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Main Board Listing - Research

中國特鋼控股有限公司

China Special Steel Holdings Company Limited [Stock Code: 2889]**Global Coordinator, Sole Bookrunner,**

: Cazenove Asia Limited

Sponsor and Lead Manager**Co-lead Managers**

: China Trust Securities

Macquarie Securities Ltd.

(HK) Ltd.

Sector : Commodities**Business** : Manufacture and Sale of Special Steel Products**Total share offer:** 180,000,000 shares
(36% of the enlarged share capital)**Public Offer:** 18,000,000 shares (10%)**Placing:** 162,000,000 shares (90%)**Greenshoe:** 27,000,000 shares**Price:** HK\$1.48 – HK\$1.85 per share**Market Cap.:** HK\$740 million – HK\$925 million**FY2004 P/E:** 6.2x – 7.7x

(On a pro forma basis)

Adjusted NTA per share: RMB1.08 – RMB1.22**Staffing:** 1,725 (as of 30th April 2005)**HK Public Offer period:**9th May 2005 - 12th May 2005 noon**Receiving bank:** Standard Chartered Bank (Hong Kong) Limited**Share registrar:** Computershare Hong Kong Investor Service Limited**Listing date:** 19th May 2005**Business of China Special Steel**

The Company is a non-State-owned special steel manufacturer, principally engaged in the production and sales of special steel – mainly bearing steel and spring steel. Since its establishment in 1993, the Company has been one of the top 5 special steel manufacturers in the Mainland, in terms of output of bearing steel.

The Company's principal special steel products include bearing steel and spring steel. Different from generic steel, special steel can be used not only in the construction industry but also in the manufacture of machinery, equipment and automobiles. Specific mixture of alloys is required for making special steel with certain chemical properties not found in generic steel. According to China Special Steel Association, there were more than 300 manufacturers in the generic steel industry in China, while there are only 20 in the special steel industry. The special steel products of the Company were sold to more than 450 customers in 23 provinces and 3 municipal cities throughout the Mainland.

The Company now operates two production lines in Gongyi, Henan Province, with convenient and easy access to railways and the highway system.

Major Shareholders after Listing (Assuming the over-allotment option is not exercised)

Mr. Dong Shutong – the Chairman and Chief Executive Officer of the Company

64%

64%

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Use of Proceeds

Net proceeds from the offer are estimated to be HK\$272 million

(Assuming the over-allotment option is not exercised, and at an issue price of HK\$1.67 each, which is the mid-point of the indicative price range)

	HK\$ million
For refinement of production process to attain maximum production capacity	94
For developing and producing pearlite – (purchase of equipment and construction of the production line)	47
For repayment of bank loans,	90
For purchasing of raw materials	28
For working capital	13

Financial Highlights

	Year ended 31 st December		
	2002 RMB '000	2003 RMB '000	2004 RMB '000
Turnover	252,406	403,062	783,240
Operating profit / (loss)	53,904	80,132	147,571
Net profit / (loss)	41,548	63,455	127,564

Breakdown of Turnover by Products

	Year ended 31 st December					
	2002		2003		2004	
	RMB (million)	%	RMB (million)	%	RMB (million)	%
Bearing Steel	169.4	67	326.9	81	642.8	82
Spring Steel	83.0	33	65.8	16	69.3	9
Carbon Structure Steel and Gear Steel	-	0	8.0	2	54.3	7
Subtotal for Steel products	252.4	100	400.7	99	766.4	98
Pig iron	-	0	2.4	1	16.8	2
Turnover	<u>252.4</u>	100.0	<u>403.1</u>	100.0	<u>783.2</u>	100.0

Selected Financial Ratios

	Year ended 31 st December		
	2002	2003	2004
Gross margin	26.4%	29.7%	20.0%
Net profit margin	16.5%	15.7%	16.3%
Current ratio	53%	24%	67%
Inventory turnover days	22 days	32 days	36 days
Interest cover	5 times	4 times	8 times
Gearing ratio	42%	43%	33%

Strengths/Opportunities

- ✓ According to industry statistics, special steel consumption in China grew at a compound annual growth rate (CAGR) of 10.7% between 2001 and 2003, while output of special steel only grew at a CAGR of 5.6% during the same period. Stronger demand growth should support robust expansion of the special steel industry in the Mainland.
- ✓ According to China Special Steel Association, special steel output accounted for 8.1% of the total steel production in China in 2003, lower than the world average between 12%-15%. Lower market penetration should leave room for further growth in the industry in the future.
- ✓ Phase II production line, one of the two production lines of the Company, commenced operation in September 2003, while the designed production capacity was boosted from 150,000 tonnes to 500,000 tonnes per year. With actual production volume at about 211,000 tonnes in 2004, there is still plenty room for further enhancement in utilization rate and production volume.

Weaknesses/Threats

- × Raw materials, mainly comprising iron ore, scrap steel and other supplementary materials such as lime, fluorite, graphite and various alloys, accounted for more than 60% of the Company's total production costs. Any rising raw materials prices would accordingly have a negative impact on the Group's profit margins. For instance, the Company's unit production costs jumped more than 45% y-o-y in 2004, eating into its gross profit margin by 10 percentage points to 20%.
- × Officials were quoted as saying that China is reducing the number of permits to import iron ore from over 500 to 118 in a bid to curb the fast-growing steel industry, after decision earlier to cut tax rebates for steel product exports. Despite sourcing iron ore mainly from local mines, the Company's cost of raw materials may rise further, as tightening iron ore supply as a result of limited imports may push up prices.
- × Nearly one-third of the proceeds raised (HK\$90 million) via the IPO would be used for repayment of bank loans of RMB95 million. Such action may give rise to negative response among potential investors.
- × The Offer Shares would be priced at 6.2x -7.7x FY2004 P/E, near the high end of industry average when compared with Angang New Steel (0347) at 7.5x FY2004 P/E, Chongqing Iron (1053) at 3.6x and Maanshan Iron (0323) at 5.3x. The valuations are not very attractive, given the worsening outlook of raw material costs. Meanwhile, investors' appetites for the IPO would also be dampened, after two other steel makers, Kunming Iron and Steel and China Guofeng Group, respectively postponed their share offerings back in February and late last year.

Recommendation: Unappealing