

China steel sector

Improving consumption outlook

	Ticker	Rec	Mkt cap		Price	PT	Up/ dn (%)	PER		PBR		EV/EBITDA	
			(US\$b)	Ccy				2016E	2017E	2016E	2017E	2016E	2017E
Angang	347 HK	Buy	4.4	HKD	3.92	5.00	27.6	na	87.0	0.5	0.5	11.4	9.1
Magang	323 HK	Buy	2.8	HKD	1.75	2.00	13.2	na	na	0.5	0.6	na	14.7

Source: Bloomberg, Company, CSCI Research estimate, price as of 8 April 2016

- We have modestly revised up our China steel consumption forecast to reflect domestic demand is likely to continue to improve during the upcoming peak consumption season. We still believe that supply-side reforms would become increasingly effective in reducing overcapacity in the medium-term.
- On the back of improved EBITDA earnings, we raise our price targets for Angang (BUY, PT HKD5.00 from HKD3.80) and Magang (BUY, PT HKD2.00 from HKD1.30), based on their corresponding 5YR historical average PBR multiples. Upgrade Magang to Buy. Angang remains our preferred sector pick.

Falling steel inventory

The YTD steel price rally has been primarily driven by restocking and is partly attributable to return of financing demand in China. Based on the latest steel PMI data (steel products stocks down to 37.7 in March versus 44.8 in February) showing a continuously improving outlook driven by new orders, we believe the trend will hold up during the peak consumption season. Accordingly, we have modestly revised up our China steel consumption estimate for 2016 (for details please refer to Figure 1), with a slightly better outlook foreseeing a flattish consumption growth this year. On the supply side, as long as China's crude steel production does not far exceed two million tons in April, our thesis of supply-driven industry rebalancing would remain intact, i.e. slowdown in supply growth will be faster than that of demand.

Idle capacity resumption progress slower than expected but closely monitored

While there are approximately a total of two millions tons of small scale capacity awaiting to resume operation after the recent steel price rally, the overall progress of production resumption has remained slow thus far as some of the mills are still faced with the problem of capital disruption due to a lack of credit support, according to our sources. As we have noticed that certain steel plants have maintained their relatively high production volume targets for this year, we have kept our net plants shutdown forecast unchanged from the previous level, although we acknowledge that bank lending should have been diminishing on the back of the supply reforms.

Improving outlook for Angang and Magang Despite both companies have reported net FY15 losses, which were partly attributable to impairment charges, Angang has demonstrated its premium pricing power over Magang in the latest set of annual results of 2015. According to our calculation, Angang's unit gross profit was RMB172, cf. Magang's unit gross loss. In 2016, both companies guided similar sales volume targets as last year; however, based on the March steel price, both companies have not yet returned to profit making. Nonetheless, we have trimmed our net loss estimates for both companies (refer to Figure 2) on the benefit of lower unit cost. For Angang, its products mix adjustment towards the higher-end downstream auto market, which should help drive unit profit recovery and consolidate its businesses given its strong balance sheet. For Magang, it is possible to see lower interest expenses from the potential help from local government from the debt refinancing due to expire this year.

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Revising up China steel consumption estimate

We have modestly revised up our China steel consumption for 2016 for two reasons. Firstly, despite policy overhang remains, we believe consumption from property is less likely to be worse than last year, based on the YTD investment and newly started floor space. Secondly, given that the funding for construction projects has been smooth thus far, based on the feedbacks, we believe infrastructure consumption growth will likely accelerate from the 2Q of this year. Hence, we have nudged up our 2016 consumption forecast by approximately 2%.

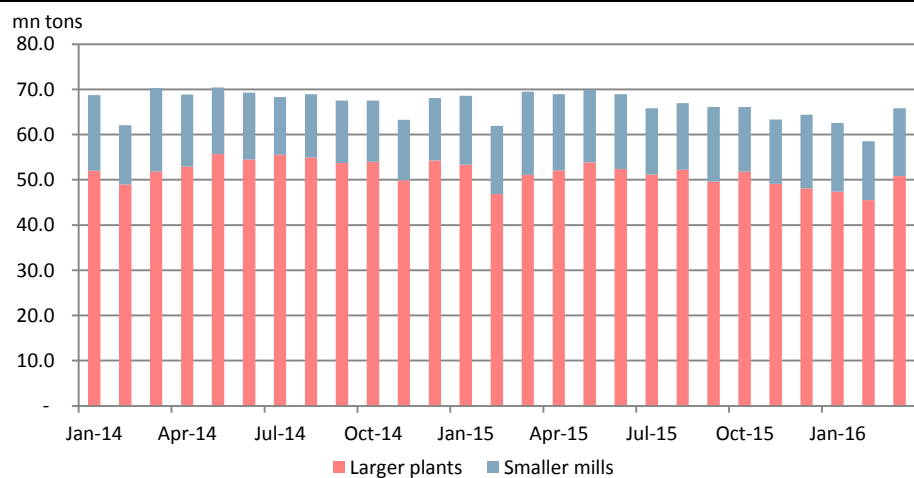
Figure 1: China crude steel industry overview

	Unit	2013	2014	2015	2016F	2017F
Crude steel						
New addition	m tons	69.2	14.6	15.6	17.0	7.0
Closure	m tons	11.5	6.5	35.0	40.0	25.0
Total capacity	m tons	1,076	1,084	1,065	1,042	1,034
Production	m tons	783	823	803	780	770
y-o-y growth	%	9.3%	5.1%	-2.4%	-2.9%	-1.3%
Utilization	%	72.8%	75.9%	75.4%	74.9%	74.5%
Net import/(export)	m tons	50.8	84.1	114.6	88.0	90.0
Inventory	m tons	12.3	8.8	8.1	8.0	8.0
Consumption	m tons	733	735	688	692	680
y-o-y growth	%	9.3%	0.3%	-6.4%	0.6%	-1.7%
Hot rolled steel	Rmb/ton	3,573	3,154	2,317	2,190	2,212
Rebar steel price	Rmb/ton	3,681	3,269	2,244	2,200	2,222
Iron ore - 62%	US\$/ton	952	670	425	390	390

Source: Bloomberg, CSCI Research estimate

On the supply side, as a case from Hebei, China's largest steel producing province, as shown in the latest PMI data, there was a continuous falling inventory even though production started to rebound. While consumption outlook remains relatively unstable, the Hebei government has told the city-level authorities to set up special funds to help steel enterprises close capacity and restructure debt, and called on banks to increase lending to competitive steel mills and support technical upgrades or shift capacity abroad, according to media. We note the increasing granularity in Hebei would set an example for other provinces to follow suit.

Figure 2: China crude steel production



Source: Bloomberg

After revision, we expect the overall capacity utilisation in 2016 to post a less serious deterioration than our previously forecast, while we also believe utilisation would improve 2018 onwards driven by the supply reform.

Earnings revision

For Angang, we have toned down our revenue estimates by 3-5% for 2016 and 2017, on the back of our new sales volume and price assumptions. Besides, we have revised down our net loss estimate for 2016 and revised up our net profit estimate for 2017 to reflect lower unit cost assumption in both years. Our revised net profit estimate remains conservative compared to consensus in 2016. We believe Angang's earnings recovery is on track as to foresee a turnaround in 2017.

For Magang, we have revised down our revenue estimates by 5-7% for 2016 and 2017, mainly on a lower products prices assumption. We have also revised down our net loss estimates by 65% for the forecasted periods on lower unit cost assumption. Our net loss estimates are below consensus in 2016. We believe Magang's risk exposure in reliance on raw material imports will be higher as compared to Angang, resulting in a slower pace of recovery expected for the forecasted period.

Figure 3: Changes to our estimates

YE Dec	Angang		Magang	
	2016E	2017E	2016E	2017E
RMB mn				
Revenue				
Prior	54,067	55,719	42,529	43,691
New	52,385	52,866	40,435	40,807
% revised	-3%	-5%	-5%	-7%
Net profit				
Prior	(1,564)	231	(3,084)	(2,475)
New	(518)	338	(1,081)	(872)
% revised	-67%	47%	-65%	-65%
EPS				
Prior	(0.22)	0.03	(0.40)	(0.32)
New	(0.07)	0.05	(0.14)	(0.11)
% revised	-67%	56%	-65%	-65%

Source: CSCI Research estimate

Figure 4: Consensus versus our estimates

YE Dec	Angang		Magang	
	2016E	2017E	2016E	2017E
RMB mn				
Revenue				
Consensus	53,341	55,108	42,209	43,222
CSCI	52,385	52,866	40,435	40,807
% deviated	-2%	-4%	-4%	-6%
Net profit				
Consensus	(691)	54	(1,824)	(1,082)
CSCI	(518)	338	(1,081)	(872)
% deviated	-25%	532%	-41%	-19%
EPS				
Consensus	(0.13)	0.03	(0.26)	(0.16)
CSCI	(0.07)	0.05	(0.14)	(0.11)
% deviated	-45%	67%	-45%	-30%

Source: Bloomberg

Raise PT for Angang and Magang, upgrade Magang to Buy, Angang remains preferred sector pick

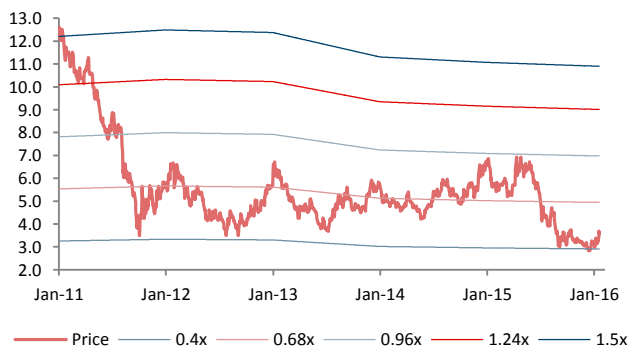
Based on the current steel price levels, we expect both companies will be capable to return to profit making in March. Considering an improving consumption outlook and that steel prices are likely to hold up during the upcoming peak consumption season as a result, we have raised our target multiples for both counters, based on their corresponding 5-year historical mean. Based on our latest PBR multiple level, we upgrade Magang to Buy as we foresee positive momentum on potentially resolving existing debt refinancing issues and seasonal strength of steel prices, and also reiterate Buy on Angang as we firmly believe that its valuation remains attractive. Meanwhile, Angang remains our preferred sector pick.

Figure 5: Changes to our valuation multiples

	Angang	Note	Magang	Note
FY16E BVPS (RMB)	5.97		2.54	
Target PBR multiple				
Prior (x)	0.5		0.4	
Target price (HKD)	3.8		1.3	
Rating	OP		IL	
New (x)	0.7	5YR mean	0.7	
Target price (HKD)	5.0		2.0	
Up/dn (%)	27.6%		13.2%	
Rating	OP		OP	

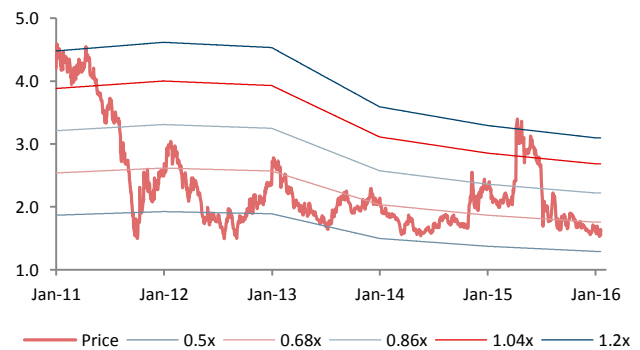
Source: CSCI Research estimate

Figure 6: Angang's PBR band



Source: Bloomberg

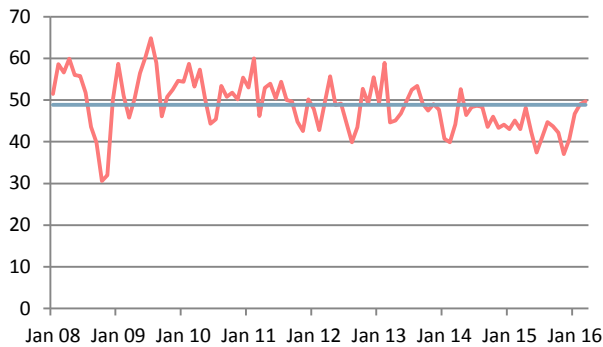
Figure 7: Magang's PBR band



Source: Bloomberg

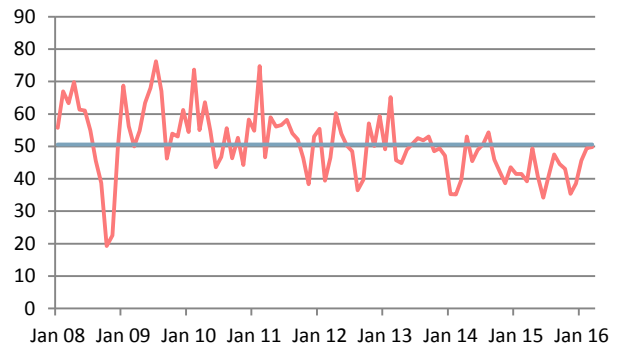
Appendix: China steel PMI

Figure 8: China steel PMI



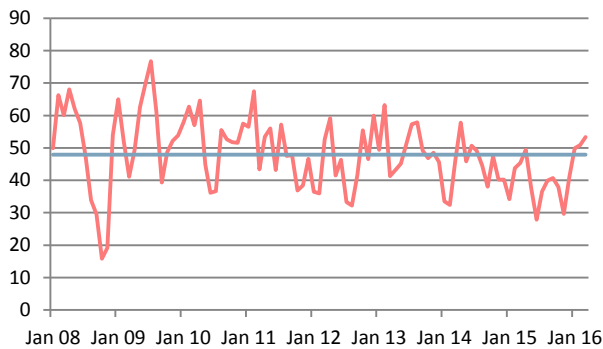
Source: Bloomberg

Figure 9: China steel production index



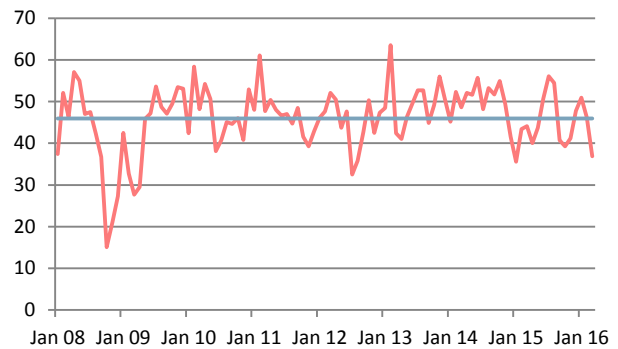
Source: Bloomberg

Figure 10: China steel new orders index



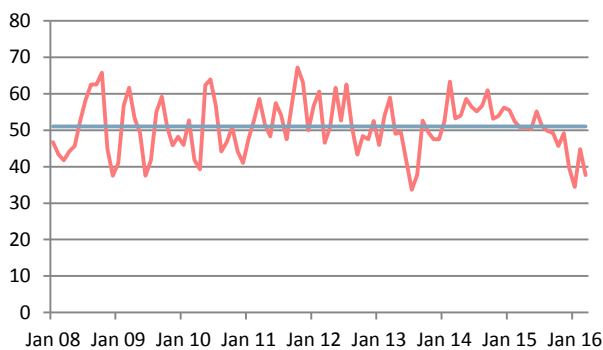
Source: Bloomberg

Figure 11: China steel export orders index



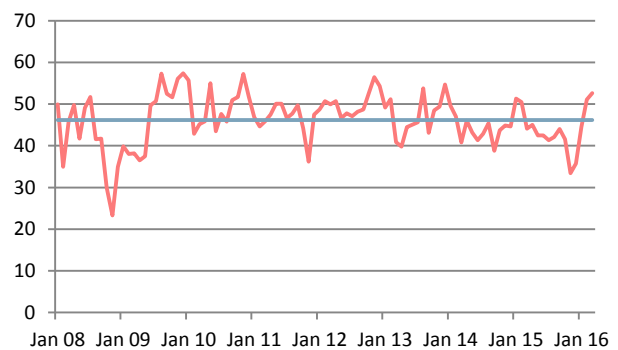
Source: Bloomberg

Figure 12: China steel products stocks index



Source: Bloomberg

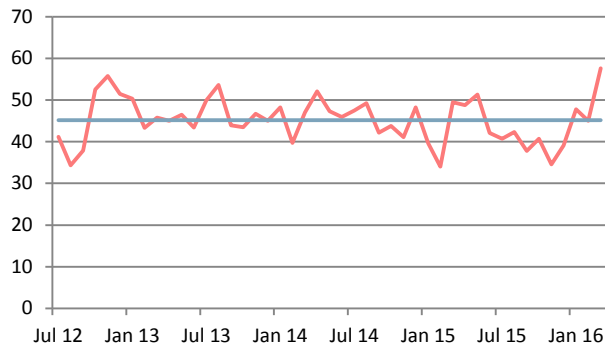
Figure 13: China steel raw materials inventory index



Source: Bloomberg

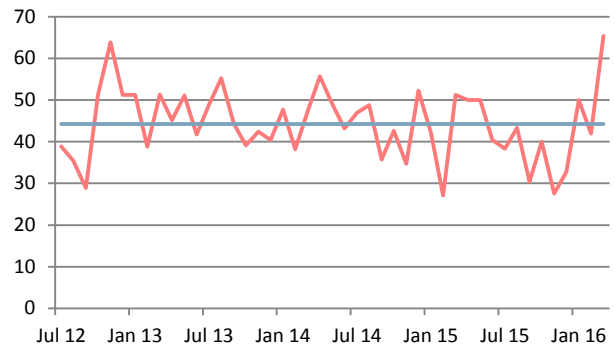
Appendix: Hebei steel PMI

Figure 14: Hebei steel PMI



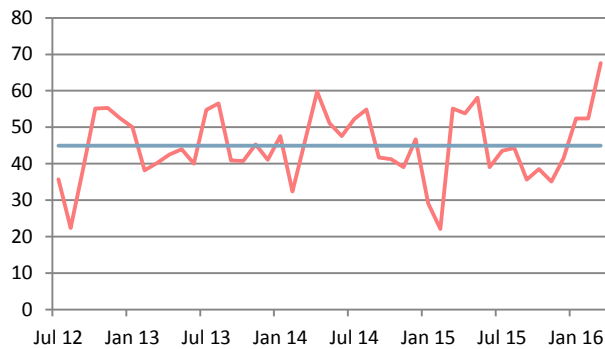
Source: Bloomberg

Figure 15: Hebei steel production index



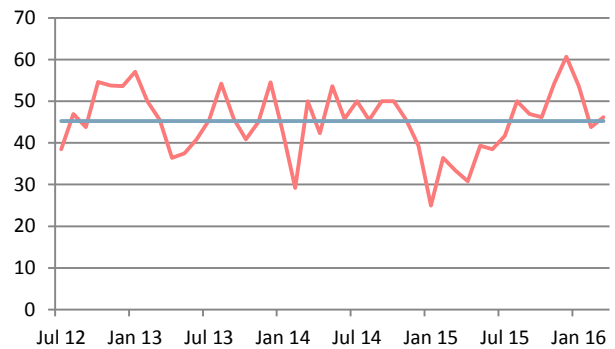
Source: Bloomberg

Figure 16: Hebei steel new orders index



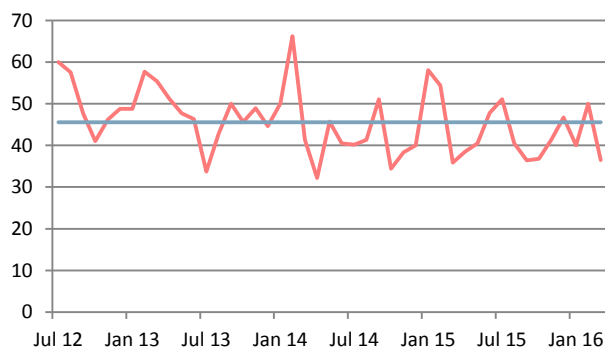
Source: Bloomberg

Figure 17: Hebei steel export orders index



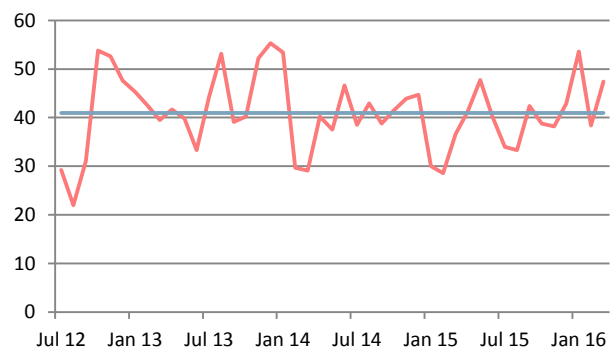
Source: Bloomberg

Figure 18: Hebei steel products stocks index



Source: Bloomberg

Figure 19: Hebei steel raw materials inventory index



Source: Bloomberg

Angang's Financial summary

Income statement (RMBm)

Year end: Dec	2013	2014	2015E	2016E	2017E
Revenue	75,329	74,046	52,759	52,385	52,866
COGS	(67,123)	(65,703)	(49,693)	(46,791)	(46,327)
Gross profit	8,206	8,343	3,066	5,594	6,539
Selling expenses	(1,743)	(2,216)	(2,311)	(2,177)	(2,197)
General and administrative	(3,270)	(1,850)	(1,808)	(1,798)	(1,815)
Other opex	(1,866)	(2,111)	(1,869)	(1,609)	(1,624)
EBITDA	6,212	6,839	1,600	4,697	5,545
Depreciation & Amortization	(4,251)	(3,984)	(4,010)	(4,185)	(3,954)
EBIT	1,961	2,855	(2,410)	512	1,590
Interest income	309	372	219	356	339
Interest expense	(1,527)	(1,644)	(1,565)	(1,559)	(1,478)
JVs and associates	619	687	505	501	687
Others	-	-	-	-	-
Pretax profit	728	1,579	(3,763)	(691)	452
Taxation	27	(655)	(837)	173	(113)
Minority interests	15	4	7	1	(1)
Net profit	770	928	(4,593)	(518)	338
Net profit (adjusted)	770	928	(4,593)	(518)	338
Basic EPS (RMB)	0.11	0.13	(0.63)	(0.07)	0.05
Diluted EPS (RMB)	0.11	0.13	(0.63)	(0.07)	0.05
DPS (RMB)	0.03	0.05	-	-	-

Cash flow statement (RMBm)

Year end: Dec	2013	2014	2015E	2016E	2017E
EBIT	1,961	2,855	(2,410)	512	1,590
Depreciation & amortisation	4,251	3,984	4,010	4,185	3,954
Net interest	121	1272	1346	1203	119
Taxes paid	27	(655)	(837)	173	(113)
Changes in working capital	4,149	(4,008)	5,010	(2,422)	(89)
Others	(1,043)	(1,311)	(730)	(2,406)	(2,277)
Cash flow from operations	10,563	2,137	6,389	1,245	4,205
Capex	(2,948)	(4,416)	(4,000)	(1,300)	(1,300)
Acquisitions	(118)	(680)	-	-	-
Disposals	28	4	-	-	-
Others	448	667	-	-	-
Cash flow from investing	(2,590)	(4,425)	(4,000)	(1,300)	(1,300)
Dividends	(1,458)	(1,636)	-	-	-
Issue of shares	-	-	-	-	-
Change in debt	(8,512)	4,167	(500)	-	(3,000)
Others	-	343	-	-	-
Cash flow from financing	(9,970)	2,874	(500)	-	(3,000)
Change in cash	(1,997)	586	1,889	(55)	(95)
Free cash flow	7,615	(2,279)	2,389	(55)	2,905

Balance sheet (RMBm)

Year end: Dec	2013	2014	2015E	2016E	2017E
Cash	126	172	3,601	3,546	3,451
Short term investments	-	-	-	-	-
Accounts receivables	10,623	8,607	8,311	8,399	8,476
Inventory	12,366	10,865	8,008	8,883	8,794
Other current assets	5,194	5,440	3,675	4,021	4,034
Total current assets	29,299	26,624	23,595	24,849	24,755
PP&E	45,452	46,122	51,014	48,129	45,475
Intangible Assets	6,147	6,234	6,086	6,086	6,086
Total investments	3,184	4,004	3,522	3,522	3,522
Other long term assets	8,783	8,307	4,379	4,379	4,379
Total long term assets	63,566	64,667	65,001	62,116	59,462
TOTAL ASSETS	92,865	91,291	88,596	86,965	84,217
Short term debt	9,241	14,672	16,319	16,319	13,451
Accounts payables	15,343	8,289	5,799	6,631	6,565
Other current liabilities	13,220	13,790	20,886	18,941	18,921
Total current liabilities	37,804	36,751	43,004	41,891	38,936
Long term debt	3,044	1,371	962	962	830
Deferred tax	956	990	949	949	949
Bonds payable	3,971	3,983	-	-	-
Other long term liabilities	-	-	-	-	-
Total long term liabilities	7,971	6,344	1,911	1,911	1,779
TOTAL LIABILITIES	45,775	43,095	44,915	43,802	40,715
Shareholders' funds	47,026	47,793	43,274	42,756	43,095
Minority interests	64	403	407	406	407
TOTAL LIAB AND EQUITY	92,865	91,291	88,596	86,965	84,217
Net cash / (debt)	(15,130)	(18,314)	(13,680)	(13,735)	(10,830)

Source: Company, CSCI Research estimate

Key ratios

Year end: Dec	2013	2014	2015E	2016E	2017E
Operating ratios					
Gross margin	10.9	11.3	5.8	10.7	12.4
EBITDA margin (%)	8.2	9.2	3.0	9.0	10.5
Effective tax rate (%)	(3.7)	4.15	(22.2)	25.0	25.0
Revenue growth (%)	(3.7)	(1.7)	(28.7)	(0.7)	0.9
Net income growth (%)	-	20.5	-	-	-
EPS growth adj (%)	-	20.5	-	-	-
DPS growth (%)	-	67.2	-	-	-
Efficiency ratios					
ROE (%)	3.6	5.2	(5.3)	1.1	3.5
Asset turnover (x)	0.8	0.8	0.6	0.6	0.6
Op cash / EBIT (x)	5.4	0.7	(2.7)	2.4	2.6
Depreciation / CAPEX (x)	14	0.9	10	3.2	3.0
Accounts receivable days	58.2	57.2	68.8	67.2	68.4
Accounts payable days	67.1	67.0	68.0	72.4	68.4
Leverage ratios					
Net gearing (%)	32.2	38.3	316	32.1	25.1
Net debt / EBITDA (x)	2.4	2.7	8.6	2.9	2.0
Interest cover (x)	16	2.2	(18)	0.4	14
Current ratio (x)	0.8	0.7	0.5	0.6	0.6
Valuation					
PER (x)	30.8	25.5	-	-	70.0
EV/EBITDA (x)	8.3	8.1	-	11.4	9.1
PBR (x)	0.5	0.5	0.5	0.5	0.5
Dividend yield (%)	0.8	14	-	-	-

Magang's Financial summary

Income statement (RMBm)

Year end: Dec	2013	2014	2015E	2016E	2017E
Revenue	73,849	59,821	45,109	40,435	40,807
COGS	(70,620)	(56,076)	(45,690)	(38,645)	(38,648)
Gross profit	3,228	3,745	(581)	1,790	2,159
Selling expenses	(423)	(513)	(636)	(530)	(535)
General and administrative	(1,334)	(1,311)	(1,539)	(1,520)	(1,534)
Other opex	(1,164)	(770)	(1,619)	(743)	(749)
EBITDA	5,191	5,270	(23)	2,794	3,009
Depreciation & Amortization	(3,766)	(3,558)	(3,590)	(3,317)	(3,198)
EBIT	1,426	1,712	(3,613)	(523)	(189)
Interest income	168	176	156	131	102
Interest expense	(1,322)	(1,419)	(969)	(1,072)	(1,094)
JVs and associates	1,169	604	461	413	417
Others	-	-	-	-	-
Pretax profit	322	512	(4,727)	(1,531)	(1,236)
Taxation	(114)	(248)	(378)	383	309
Minority interests	(51)	(43)	300	68	55
Net profit	157	221	(4,804)	(1,081)	(872)
Net profit (adjusted)	157	221	(4,804)	(1,081)	(872)
Basic EPS (RMB)	0.02	0.03	(0.62)	(0.14)	(0.11)
Diluted EPS (RMB)	0.02	0.03	(0.62)	(0.14)	(0.11)
DPS (RMB)	-	-	-	-	-

Cash flow statement (RMBm)

Year end: Dec	2013	2014	2015E	2016E	2017E
EBIT	1,426	1,712	(3,613)	(523)	(189)
Depreciation & amortisation	3,766	3,558	3,590	3,317	3,198
Net interest	154	1,244	813	941	993
Taxes paid	(114)	(248)	(378)	383	309
Changes in working capital	(440)	(2,641)	6,526	(3,133)	(61)
Others	(700)	(2,059)	(3,604)	(1,949)	(2,040)
Cash flow from operations	5,091	1,566	3,334	(965)	2,210
Capex	(5,521)	(2,708)	(2,846)	(2,246)	(2,000)
Acquisitions	(88)	(105)	-	-	-
Disposals	761	1,629	-	-	-
Others	305	2,511	-	-	-
Cash flow from investing	(4,543)	1,326	(2,846)	(2,246)	(2,000)
Dividends	(1,294)	(1,401)	-	-	-
Issue of shares	-	-	-	-	-
Change in debt	(4,288)	(1,974)	-	1,000	-
Others	281	30	-	-	-
Cash flow from financing	(5,301)	(3,344)	-	1,000	-
Change in cash	(4,752)	(452)	488	(2,211)	210
Free cash flow	(429)	(1,142)	488	(3,211)	210

Balance sheet (RMBm)

Year end: Dec	2013	2014	2015E	2016E	2017E
Cash	5,107	4,655	5,143	2,932	3,142
Short term investments	-	-	-	-	-
Accounts receivables	8,629	8,484	4,689	5,904	5,958
Inventory	10,500	8,684	6,018	6,216	6,216
Other current assets	4,811	3,063	4,310	4,254	4,261
Total current assets	28,597	24,885	20,160	19,306	19,578
PP&E	30,668	37,041	34,605	33,535	32,337
Intangible Assets	1,900	1,826	1,891	1,891	1,891
Total investments	1,077	1,216	1,159	1,159	1,159
Other long term assets	9,579	3,542	4,639	4,639	4,639
Total long term assets	43,225	43,626	42,294	41,223	40,025
TOTAL ASSETS	71,822	68,511	62,454	60,529	59,603
Short term debt	8,554	12,058	6,791	7,319	7,319
Accounts payables	6,524	6,679	6,145	5,422	5,422
Other current liabilities	22,011	13,967	16,795	15,741	15,742
Total current liabilities	37,088	32,705	29,731	28,482	28,483
Long term debt	6,059	6,339	6,655	7,128	7,128
Deferred tax	647	1,245	1,347	1,347	1,347
Bonds payable	2,328	2,333	3,980	3,980	3,980
Other long term liabilities	-	-	-	-	-
Total long term liabilities	9,034	9,917	11,982	12,454	12,454
TOTAL LIABILITIES	46,123	42,622	41,713	40,936	40,937
Shareholders' funds	23,131	23,296	18,456	17,375	16,503
Minority Interests	2,568	2,594	2,286	2,218	2,164
TOTAL LIAB AND EQUITY	71,822	68,511	62,454	60,529	59,603
Net cash / (debt)	(11,835)	(16,076)	(12,283)	(15,495)	(15,284)

Source: Company, CSC Research estimate

Key ratios

Year end: Dec	2013	2014	2015E	2016E	2017E
Operating ratios					
Gross margin	4.4	6.3	(1.3)	4.4	5.3
EBITDA margin (%)	7.0	8.8	(0.1)	6.9	7.4
Effective tax rate (%)	35.5	48.4	(8.0)	25.0	25.0
Revenue growth (%)	(0.7)	(19.0)	(24.6)	(10.4)	0.9
Net income growth (%)	-	40.3	-	-	-
EPS growth adj (%)	-	40.3	-	-	-
DPS growth (%)	-	-	-	-	-
Efficiency ratios					
ROE (%)	4.1	4.8	(11.0)	(1.6)	(0.6)
Asset turnover (x)	1.0	0.9	0.7	0.7	0.7
Op cash / EBIT (x)	3.6	0.9	(0.9)	1.8	(1.1)
Depreciation / CAPEX (x)	0.7	1.3	1.3	1.5	1.6
Accounts receivable days	46.7	57.3	60.0	54.8	59.7
Accounts payable days	62.7	77.0	92.2	100.6	92.2
Leverage ratios					
Net gearing (%)	51.2	69.0	66.6	89.2	92.6
Net debt / EBITDA (x)	2.3	3.1	(522.9)	5.5	5.1
Interest cover (x)	1.2	1.4	(4.4)	(0.6)	(0.2)
Current ratio (x)	0.8	0.8	0.7	0.7	0.7
Valuation					
PER (x)	7.16	5.10	-	-	-
EV/EBITDA (x)	8.1	7.7	-	-	14.7
PBR (x)	0.4	0.4	0.5	0.6	0.6
Dividend yield (%)	-	-	-	-	-



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Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

Buy	12-month absolute total return: $\geq 10\%$
Hold	12-month absolute total return: $> -10\%$ but $< 10\%$
Sell	12-month absolute total return: $\leq -10\%$

Disclosure of Interests

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