

China Steel Sector

On-track supply-side reform underpins earnings recovery

	Ticker	Rec	Mkt cap		Price	PT	Up/ dn (%)	PBR (x)		EV/EBITDA (x)		ROE (%)	ND/E (%)
			(US\$b)	Ccy				2017E	2018E	2017E	2018E	2017E	2017E
Angang	347 HK	Buy	5.5	HKD	5.33	6.5	22.0	0.7	0.7	8.3	7.5	4.2	39.6
Magang	323 HK	Buy	3.5	HKD	2.83	3.5	23.7	0.8	0.7	5.1	4.8	9.1	27.9

*closing price dated as of Jun 14, 2017

Source: Bloomberg, CSCI estimates

- China's supply-side reform appears to be paid off for the steel industry, as suggested by May 2017 data. Besides, China Iron & Steel Association data showed that China's daily crude steel production dropped 3% during late-May as compared to the level in mid-May, with the overall utilisation staying at a relatively lower level.
- On the demand side, we expect to see stable order books for steel products as suggested by downstream production indicators, which helps keep steel inventory low.
- We believe China's steel sector would benefit from the continuous structural supply reform amid stabilising traditional economic activity as well as increasing market bargaining power amid rising industry consolidation.

Positive data for further deceleration of China's steel production in May. According to National Bureau of Statistics of China, the production growth of China's crude steels and steel products in May reached 1.8% and -1.9%, respectively. The corresponding production growth rates were 4.4% and 0.8% during the first five months of 2017. We attribute the slowing production growth to the upcoming deadline (Jun 30 2017) of "ground steel strips" closure program and the ongoing closure plan of crude steel capacities (the 50mn tons target for this year) set by NDRC.

Updates on China's steel supply reform. China's iron ore inventory level at ports hit record high of 140mn tons by Jun 9, partly due to the decreasing demand resulted from crude steel capacity closure, but also the increasing supply of scrap steels as substitutes for steel production. We expect the ongoing supply-side reform to penetrate into the whole supply chain in China's steel industry. We stay optimistic on the continuous industry consolidation after the Bao-Wu merger and expect to see strengthening bargaining power of Chinese steel mills in the global market.

Focus on 3Q17. According to our calculation on the spot steel prices and material costs, China's hot-rolled steel product price spread returned back in positive territory recently from a loss in the past few months, mainly due to stabilising prices supported by pent-up orders from auto manufacturers and declining iron ore costs. Based on the latest downstream production data *please refer to Figure 1*, we believe demand will largely maintain stable in the near term, which would support steel prices to remain at current level.

Continuous improving industry fundamentals support valuation re-rating, preferred Magang. Angang (347 HK, Buy, PT HKD6.5) and Magang (323 HK, Buy, PT HKD3.5) are current trading at 0.7x and 0.8x FY17E PBR respectively, underpinned by continuous improving industry prospect. Magang remained our preferred sector pick.

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China steel industry summary

Figure 1: China steel industry

	Unit	May	% chg	5M17	% chg
Crude production	mn tons	72.3	1.8%	346.8	4.4%
Steel products	mn tons	95.8	-1.9%	453.7	0.8%
Export	mn tons	7.0	-99.3%	34.2	-26.2%
Import	mn tons	1.1	1.8%	5.7	6.6%
Net export	mn tons	5.9	-15.9%	28.5	-16.6%
Inventory drawdown					
Merchants	mn tons	(1.9)	-	0.8	-
Mills	mn tons	0.0	-	0.0	-
Apparent consumption	mn tons	91.8	1.2%	424.3	1.8%
Downstream production indicator					
Metal-cutting machine tool	mn units	0.1	16.7%	0.3	10.1%
Industrial robot	unit/set	10,057	47.3%	44,360	50.4%
Automobiles	mn units	2.2	4.1%	11.7	6.4%
SUV	unit/set	70	15.5%	390	20.8%
New energy vehicles	mn units	4.7	27.0%	14.1	7.6%
Power equipments	mn kW	12	-20.1%	49	1.5%
Micro-computer equipments	mn units	24	2.2%	113	2.1%
Mobile communication handset	mn units	149	0.0%	769	9.1%
Smartphones	mn units	105	-4.5%	564	7.5%
Integrated circuit	mn units	13,600	25.0%	59,900	25.1%

Source: Wind, CSCI Research

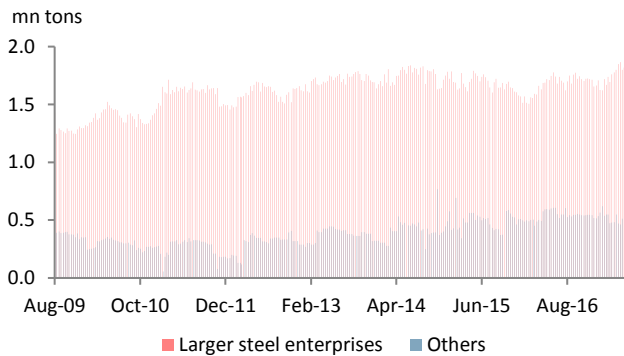
Figure 2: China steel prices

	Unit	2012	2013	2014	2015	2016	2017YTD
Hot rolled steel	RMB/ton	3,999	3,681	3,269	2,244	2,763	3,488
Rebar steel price	RMB/ton	3,930	3,573	3,154	2,317	2,628	3,736
Import Fe62%	RMB/ton	922	952	670	425	468	612
Hebei iron ore	RMB/ton	1,092	1,077	860	580	584	734
QHD coal	RMB/ton	702	582	512	405	467	612
Coke	RMB/ton	1,750	1,465	1,084	872	1,281	1,971

Source: Bloomberg

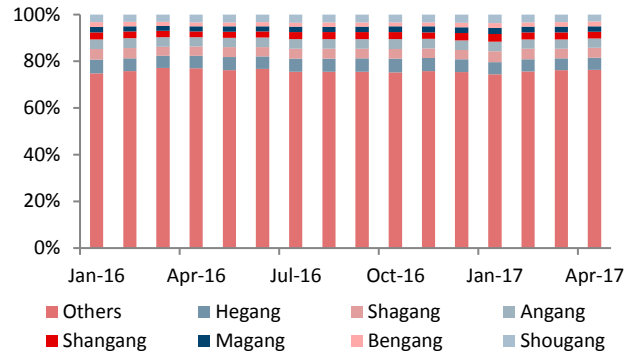
Focus charts

Figure 3: China crude steel daily production



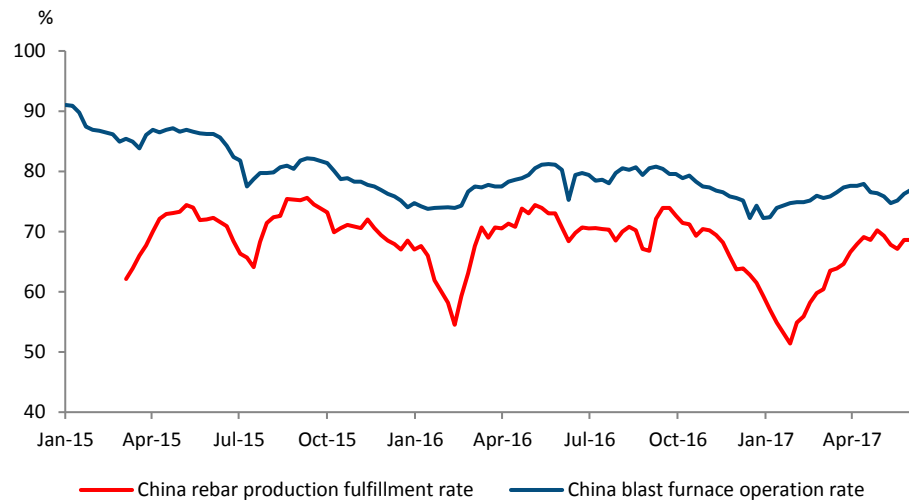
Source: Wind

Figure 4: China crude steel production by producers



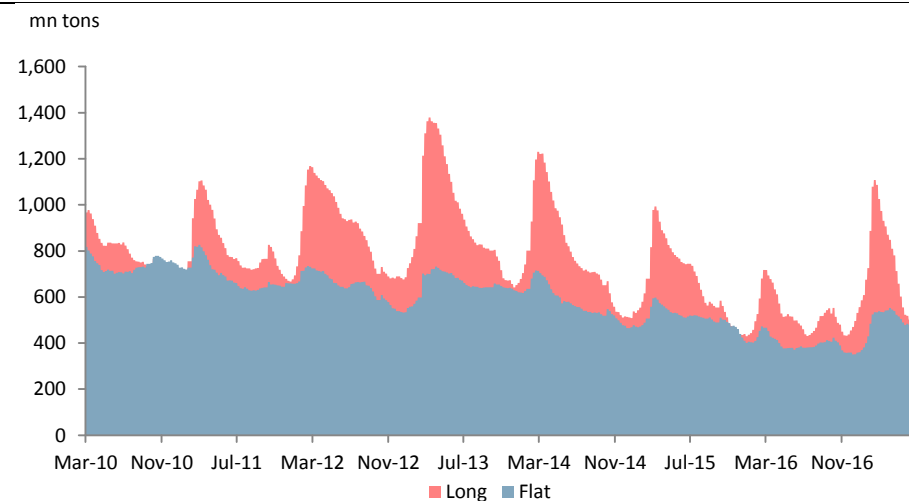
Source: Wind

Figure 5: Capacity utilisation



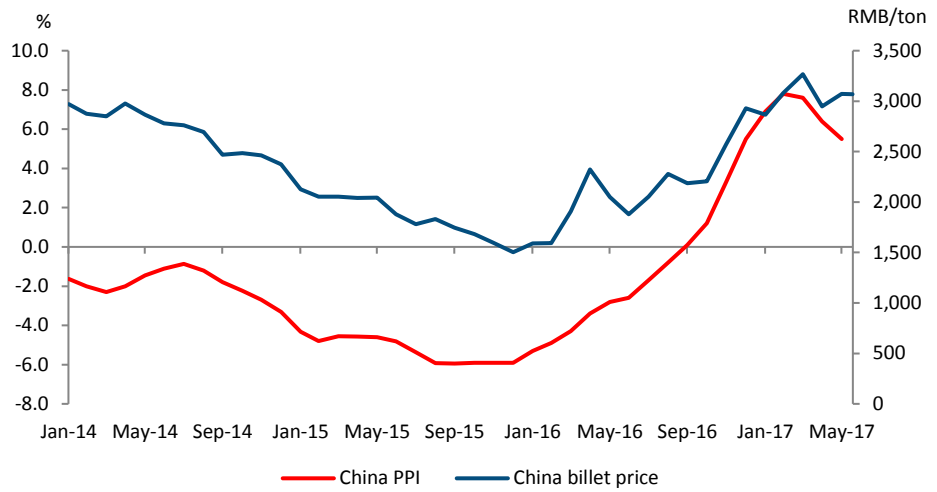
Source: Wind

Figure 6: China steel products inventory



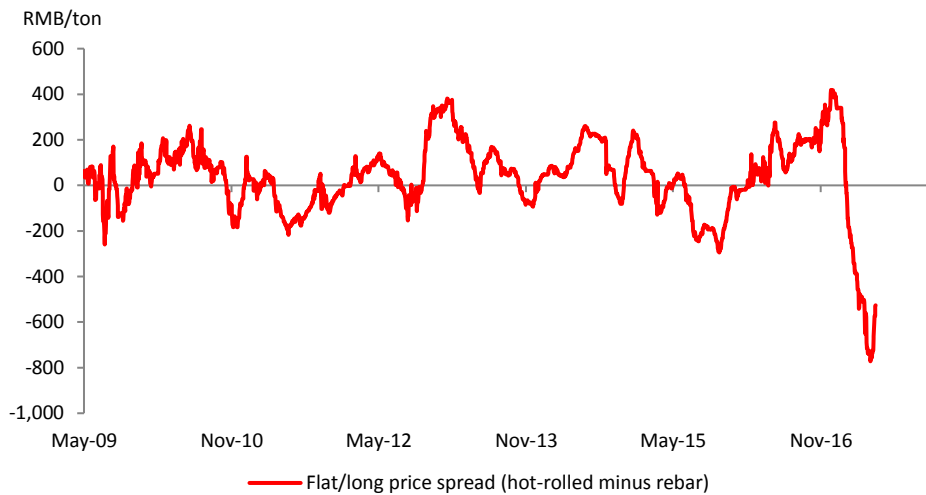
Source: Wind

Figure 7: China producer price index and steel price



Source: Wind

Figure 8: Steel product price spread



Source: Bloomberg

Figure 9: China hot-rolled price spread

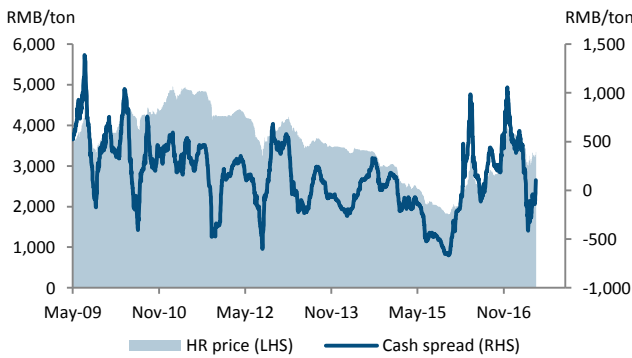
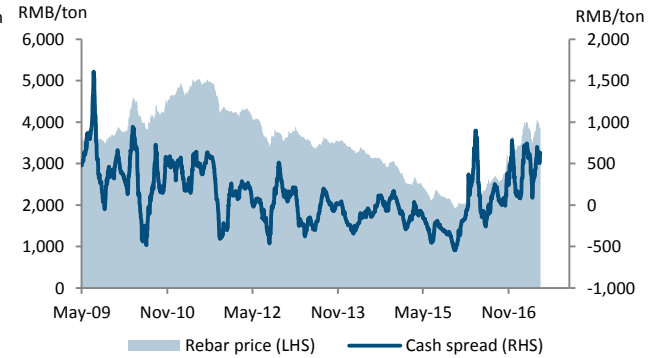
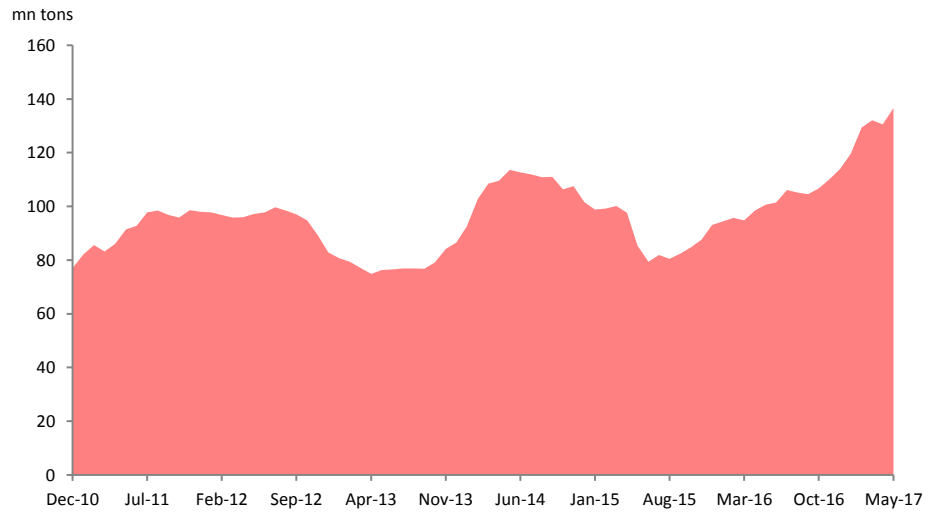


Figure 10: China rebar price spread



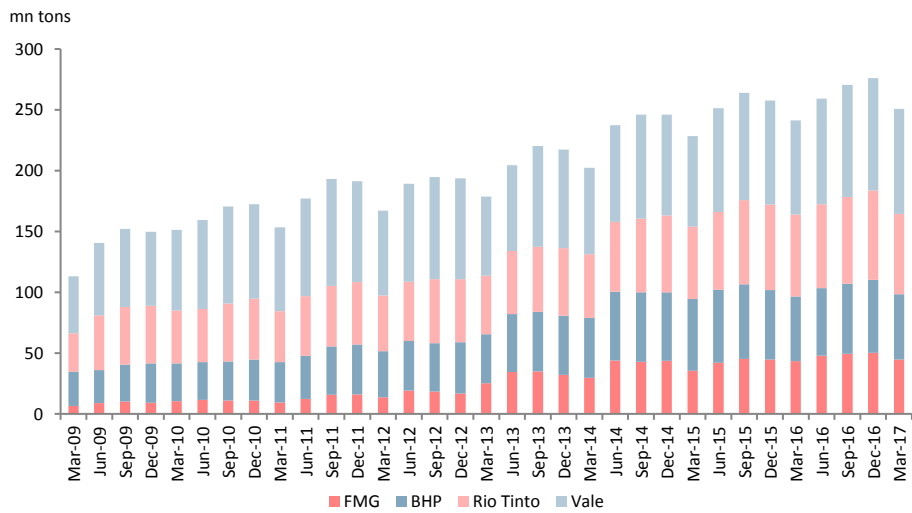
Source: Bloomberg, CSCI Research estimates

Figure 11: China iron ore inventory at ports



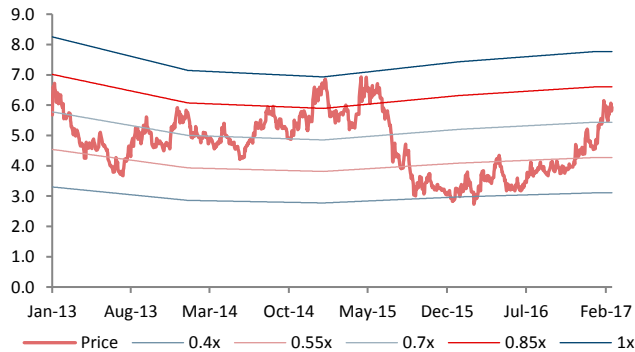
Source: Wind

Figure 12: Global iron ore producers output



Source: Wind

Valuation

Figure 13: Angang's PBR band


Source: Bloomberg, CSCI Research estimates

Figure 14: Magang's PBR band


Source: Bloomberg, CSCI Research estimates

Figure 15: Peer valuation

Company	Ticker	Ccy	Close (Local\$)	Mkt cap (US\$b)	PER (x)		EPS Growth (%)		PBR (x)		ROE (%)		EV/EBITDA (x)		Yield (%)	Net debt / Equity (%)
					2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2017E
Glencore	805 HK	HKD	29.45	54.4	11.5	13.2	184.3	(12.5)	1.1	1.1	11.1	9.5	6.0	6.2	0.4	55.9
Zijin	2899 HK	HKD	2.64	10.4	13.0	11.3	83.3	14.2	1.6	1.4	12.7	12.8	10.0	8.9	3.6	100.1
CMoC	3993 HK	HKD	2.73	10.0	23.3	18.4	82.1	25.5	1.7	1.7	7.2	9.4	16.1	14.3	1.5	N/A
CHALCO	2600 HK	HKD	3.93	8.9	19.4	14.4	535.7	32.0	1.2	1.1	7.1	8.2	9.6	8.7	0.4	168.9
RUSAL	486 HK	HKD	3.76	7.3	6.2	5.5	59.2	12.8	1.7	1.3	29.8	24.6	8.3	8.1	0.3	159.6
Jiangxi Copper	358 HK	HKD	12.18	7.0	18.4	16.6	63.6	11.1	0.8	0.8	4.4	4.8	10.1	9.1	2.0	8.9
Angang	347 HK	HKD	5.33	5.5	16.7	13.5	20.7	23.4	0.7	0.7	4.2	5.0	8.3	7.5	1.8	39.6
Magang	323 HK	HKD	2.83	3.5	9.5	9.0	61.1	5.5	0.8	0.7	9.1	8.8	5.1	4.8	-	27.9
MMG	1208 HK	HKD	2.65	2.7	7.6	6.3	1,400.0	20.0	9.7	5.6	87.6	131.5	6.7	6.6	-	477.2
Zhaojin	1818 HK	HKD	6.49	2.7	28.7	25.2	10.2	16.0	1.5	1.4	5.4	5.9	15.4	14.3	1.0	80.2
CGI	2099 HK	HKD	12.16	0.6	53.8	21.1	N/A	155.2	0.4	0.4	0.8	2.0	N/A	N/A	N/A	N/A
CGNM	1164 HK	HKD	0.61	0.5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
CNMC	1258 HK	HKD	1.15	0.5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Jinchuan	2362 HK	HKD	0.81	0.5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Average					18.7	13.9	253.6	27.4	1.9	1.5	16.4	20.3	9.7	9.0	1.2	128.5

Source: Bloomberg

Figure 16: Angang

Income statement (RMB mn)						Cash flow statement (RMB mn)					
Year end: Dec	2015	2016	2017E	2018E	2019E	Year end: Dec	2015	2016	2017E	2018E	2019E
Revenue	52,759	57,882	60,675	61,237	61,804	EBIT	(2,417)	2,906	3,683	4,199	4,720
COGS	(49,693)	(50,457)	(52,254)	(52,257)	(52,260)	Depreciation & amortisation	3,925	3,924	3,667	3,495	3,335
Gross profit	3,066	7,425	8,420	8,980	9,545	Net interest	1,346	1,286	898	762	626
Selling expenses	(2,311)	(1,928)	(2,021)	(2,040)	(2,059)	Taxes paid	(837)	(5)	(836)	(1,031)	(1,228)
General and administrative	(1,808)	(1,626)	(1,704)	(1,720)	(1,736)	Changes in working capital	4,407	(1,287)	223	(96)	(97)
Other opex	(1,364)	(965)	(1,012)	(1,021)	(1,030)	Others	(1,287)	(7,672)	(1,795)	(1,523)	(1,252)
EBIT	(2,417)	2,906	3,683	4,199	4,720	Cash flow from operations	5,137	(848)	5,840	5,805	6,104
Interest income	219	79	272	254	237	Capex	(3,807)	(1,300)	(1,300)	(1,300)	(1,300)
Interest expense	(1,565)	(1,365)	(1,169)	(1,016)	(863)	Acquisitions	(70)	-	-	-	-
JVs and associates	340	335	351	354	358	Disposals	4	-	-	-	-
Pretax profit	(3,763)	1,620	2,786	3,437	4,094	Others	145	-	-	-	-
Taxation	(837)	(5)	(836)	(1,031)	(1,228)	Cash flow from investing	(2,728)	(1,300)	(1,300)	(1,300)	(1,300)
Minority interests	7	1	1	1	2	Dividends	(1,782)	(485)	(586)	(723)	(861)
Net profit	(4,593)	1,616	1,951	2,408	2,867	Issue of shares	-	-	-	-	-
Net profit (adjusted)	(4,593)	1,616	1,951	2,408	2,867	Change in debt	1,262	1,000	(3,000)	(3,000)	(3,000)
Depreciation & Amortization	(3,925)	(3,924)	(3,667)	(3,495)	(3,335)	Others	4	-	-	-	-
EBITDA	1,508	6,830	7,350	7,694	8,054	Cash flow from financing	(516)	515	(3,586)	(3,723)	(3,861)
Basic EPS (RMB)	(0.63)	0.22	0.27	0.33	0.40	Change in cash	1,893	(1,633)	955	782	943
Diluted EPS (RMB)	(0.63)	0.22	0.27	0.33	0.40	Free cash flow	1,330	(2,148)	4,540	4,505	4,804
DPS (RMB)	-	0.07	0.08	0.10	0.12						

Balance sheet (RMB mn)						Key ratios					
Year end: Dec	2015	2016	2017E	2018E	2019E	Year end: Dec	2015	2016	2017E	2018E	2019E
Cash	3,601	1,968	2,923	3,705	4,649	Operating ratios					
Short term investments	-	-	-	-	-	Gross margin	5.8	12.8	13.9	14.7	15.4
Accounts receivables	8,311	8,352	8,733	8,814	8,896	EBITDA margin (%)	2.9	11.8	12.1	12.6	13.0
Inventory	8,008	10,466	9,565	9,565	9,565	Effective tax rate (%)	(22.2)	0.3	30.0	30.0	30.0
Other current assets	3,675	4,890	4,554	4,569	4,584	Revenue growth (%)	-	9.7	4.8	0.9	0.9
Total current assets	23,595	25,676	25,776	26,654	27,694	Net income growth (%)	-	-	20.7	23.4	19.1
PP&E	5,104	49,065	46,698	44,503	42,468	EPS growth adj (%)	-	-	20.7	23.4	19.1
Intangible Assets	6,086	5,755	5,755	5,755	5,755	DPS growth (%)	-	-	-	-	-
Total investments	3,522	3,807	3,807	3,807	3,807	Efficiency ratios					
Other long term assets	4,379	3,766	3,766	3,766	3,766	ROE (%)	(10.6)	3.6	4.2	5.0	5.7
Total long term assets	65,001	62,393	60,026	57,831	55,796	ROCE (%)	(5.3)	5.7	7.1	7.9	8.7
TOTAL ASSETS	88,596	88,069	85,802	84,486	83,491	Asset turnover (x)	0.6	0.7	0.7	0.7	0.7
Short term debt	16,319	18,995	16,639	14,284	11,928	Op cash / EBIT (x)	(2.1)	(0.3)	1.6	1.4	1.3
Accounts payables	5,799	10,055	8,209	8,209	8,209	Depreciation / CAPEX (x)	10	3.0	2.8	2.7	2.6
Other current liabilities	20,886	7,739	8,954	8,954	8,954	Accounts receivable days	68.8	62.2	62.1	61.9	61.9
Total current liabilities	43,004	36,789	33,802	31,446	29,091	Accounts payable days	68.0	78.6	80.8	78.6	78.6
Long term debt	962	1,296	652	7	(637)	Leverage ratios					
Deferred tax	949	752	752	752	752	Net gearing (%)	316	49.6	39.6	30.3	21.2
Bonds payable	-	3,944	3,944	3,944	3,944	Net debt / EBITDA (x)	9.1	3.3	2.5	1.9	1.3
Other long term liabilities	-	-	-	-	-	Interest cover (x)	(18)	2.3	4.1	5.5	7.5
Total long term liabilities	1,911	5,992	5,348	4,703	4,059	Current ratio (x)	0.5	0.7	0.8	0.8	1.0
TOTAL LIABILITIES	44,915	42,781	39,150	36,150	33,150	Valuation					
Shareholders' funds	43,274	44,882	46,248	47,933	49,940	PER (x)	-	20.8	16.7	13.5	11.3
Minority interests	407	406	405	403	402	EV/EBITDA (x)	40.5	9.5	8.3	7.5	6.6
TOTAL LIAB AND EQUITY	88,596	88,069	85,802	84,486	83,491	PBR (x)	0.8	0.7	0.7	0.7	0.6
Net cash / (debt)	(13,680)	(22,267)	(18,312)	(14,530)	(10,586)	Dividend yield (%)	-	14	18	2.2	2.6

Source: Company, Bloomberg, CSCI Research estimates

Figure 17: Magang

Income statement (RMB mn)						Cash flow statement (RMB mn)					
Year end: Dec	2015	2016	2017E	2018E	2019E	Year end: Dec	2015	2016	2017E	2018E	2019E
Revenue	45,109	48,275	53,833	54,339	54,339	EBIT	(3,914)	2,162	3,464	3,491	3,491
COGS	(45,690)	(42,990)	(46,886)	(47,333)	(47,333)	Depreciation & amortisation	3,380	3,569	3,657	3,594	3,538
Gross profit	(581)	5,286	6,947	7,007	7,007	Net interest	83	794	764	642	543
Selling expenses	(636)	(695)	(775)	(782)	(782)	Taxes paid	(378)	(112)	(675)	(712)	(737)
General and administrative	(1,539)	(1,780)	(1,985)	(2,004)	(2,004)	Changes in working capital	5,225	(4,747)	2,035	(25)	-
Other opex	(1,158)	(648)	(723)	(730)	(730)	Others	739	503	(1,528)	(1,283)	(1,086)
EBIT	(3,914)	2,162	3,464	3,491	3,491	Cash flow from operations	5,865	2,169	7,716	5,706	5,749
Interest income	166	49	52	57	58	Capex	(2,846)	(3,000)	(3,000)	(3,000)	(3,000)
Interest expense	(969)	(843)	(816)	(699)	(601)	Acquisitions	(5,405)	-	-	-	-
JVs and associates	461	233	260	262	262	Disposals	4,324	-	-	-	-
Pretax profit	(4,727)	1,369	2,700	2,849	2,948	Others	306	-	-	-	-
Taxation	(378)	(112)	(675)	(712)	(737)	Cash flow from investing	(3,621)	(3,000)	(3,000)	(3,000)	(3,000)
Minority interests	300	(28)	(45)	(47)	(49)	Dividends	(108)	-	-	-	-
Net profit	(4,804)	1,229	1,980	2,090	2,162	Issue of shares	-	-	-	-	-
Net profit (adjusted)	(4,804)	1,229	1,980	2,090	2,162	Change in debt	(4,455)	1,000	(4,000)	(2,000)	(3,000)
Depreciation & Amortization	(3,380)	(3,569)	(3,657)	(3,594)	(3,538)	Others	3,981	-	-	-	-
EBITDA	(533)	5,732	7,120	7,085	7,029	Cash flow from financing	(1,555)	1,000	(4,000)	(2,000)	(3,000)
Basic EPS (RMB)	(0.62)	0.16	0.26	0.27	0.28	Change in cash	689	169	716	706	(251)
Diluted EPS (RMB)	(0.62)	0.16	0.26	0.27	0.28	Free cash flow	3,019	(831)	4,716	2,706	2,749
DPS (RMB)	-	-	-	-	-						

Balance sheet (RMB mn)						Key ratios					
Year end: Dec	2015	2016	2017E	2018E	2019E	Year end: Dec	2015	2016	2017E	2018E	2019E
Cash	5,143	5,312	6,028	6,734	6,483	Operating ratios					
Short term investments	-	-	-	-	-	Gross margin	(13)	10.9	12.9	12.9	12.9
Accounts receivables	4,689	3,608	4,626	4,670	4,670	EBITDA margin (%)	(12)	119	13.2	13.0	12.9
Inventory	6,018	10,548	9,032	9,118	9,118	Effective tax rate (%)	(8.0)	8.2	25.0	25.0	25.0
Other current assets	4,310	4,950	5,014	5,022	5,022	Revenue growth (%)	-	7.0	115	0.9	-
Total current assets	20,160	24,418	24,700	25,545	25,293	Net income growth (%)	-	(25.6)	611	5.5	3.5
PP&E	34,605	35,523	34,866	34,272	33,734	EPS growth adj (%)	-	(25.6)	611	5.5	3.5
Intangible Assets	1,891	1,822	1,822	1,822	1,822	DPS growth (%)	-	-	-	-	-
Total investments	1,159	1,818	1,818	1,818	1,818	Efficiency ratios					
Other long term assets	4,639	2,665	2,665	2,665	2,665	ROE (%)	(26.0)	6.2	9.1	8.8	8.3
Total long term assets	42,294	41,827	41,171	40,576	40,039	ROCE (%)	(12.0)	6.6	10.6	10.3	10.0
TOTAL ASSETS	62,454	66,246	65,871	66,121	65,332	Asset turnover (x)	0.7	0.7	0.8	0.8	0.8
Short term debt	6,791	6,943	4,839	3,787	2,209	Op cash / EBIT (x)	(15)	10	2.2	16	16
Accounts payables	6,145	6,669	6,986	7,052	7,052	Depreciation / CAPEX (x)	12	12	12	12	12
Other current liabilities	16,795	19,939	21,222	21,268	21,268	Accounts receivable days	60.0	37.6	34.0	37.5	37.6
Total current liabilities	29,731	33,550	33,047	32,108	30,530	Accounts payable days	92.2	93.2	86.9	92.8	93.2
Long term debt	6,655	5,163	3,267	2,319	897	Leverage ratios					
Deferred tax	1,347	1,464	1,464	1,464	1,464	Net gearing (%)	66.6	54.6	27.9	14.1	2.3
Bonds payable	3,980	3,988	3,988	3,988	3,988	Net debt / EBITDA (x)	(23.0)	19	0.9	0.5	0.1
Other long term liabilities	-	-	-	-	-	Interest cover (x)	(4.8)	2.7	4.5	5.4	6.4
Total long term liabilities	11,982	10,615	8,719	7,770	6,348	Current ratio (x)	0.7	0.7	0.7	0.8	0.8
TOTAL LIABILITIES	41,713	44,165	41,765	39,878	36,878	Valuation					
Shareholders' funds	18,456	19,764	21,744	23,834	25,996	PER (x)	(4.0)	15.5	9.5	9.0	8.7
Minority interests	2,286	2,316	2,361	2,408	2,457	EV/EBITDA (x)	(87.4)	7.2	5.1	4.8	4.4
TOTAL LIAB AND EQUITY	62,454	66,246	65,871	66,121	65,332	PBR (x)	0.9	0.9	0.8	0.7	0.7
Net cash / (debt)	(12,283)	(10,782)	(6,066)	(3,360)	(611)	Dividend yield (%)	-	-	-	-	-

Source: Company, Bloomberg, CSCI Research estimates



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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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