

China Steel Sector

Our channel checks suggest downstream demand to remain stable

	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	6.3	HKD	6.07	6.5	7.1	0.8	0.8	8.2	7.5	5.5	39.3
Magang	323 HK	Buy	4.5	HKD	3.61	4.0	10.8	1.0	0.9	5.8	5.1	10.3	26.6

*closing price dated as of Jul 14, 2017

Source: Bloomberg, CSC estimates

- **The progress of China's steel industry de-capacity appears to have come well ahead of schedule. According to data from the China Iron & Steel Association, China's daily production of crude steel has dropped 1% MoM in Jun-17 (though still up 3% YoY), with a declining share of production from smaller plants (to one-third in Jun-17, from 28% Jan-17).**
- **Given that the social inventory is anticipated to remain at a low level, we believe the order recovery in the downstream markets since 2Q17 will be sustainable going into 2H17. While capacity closure will be an ongoing issue, we expect to see an accelerating pace in industry consolidation in 2H17.**
- **Following Angang's positive profit alert, we also expect a strong 1H17 for Magang. Angang and Magang trades at FY17E PBR of 0.8x and 1.0x, respectively, which still look attractive from a historical perspective.**

Positive read from the industry de-capacity progress. The closure of ground steel strips as of end-June and the year to-date capacity closure under the NDRC's official plan have contributed to the total market supply reductions thus far this year. According to the data published by the China Iron & Steel Association, China's crude steel production posted its first monthly decline in June this year. And after crosschecking with the latest social inventory level, which came back to a low level in end-Dec last year, confirming our view that the supply reform policies have consistently improved the market dynamics.

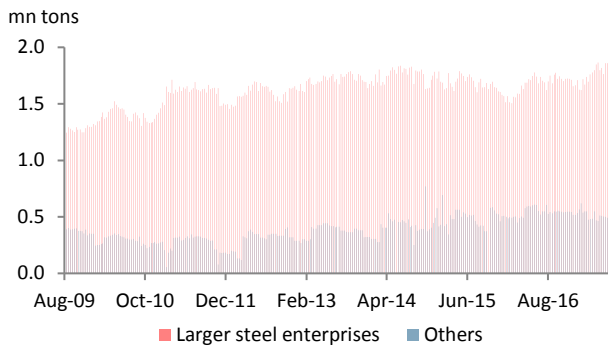
Downstream orders to remain steady. Based on our conversations with those steel mills and merchants that operated in the Yangtze River Delta region, we noticed that downstream orders have picked up steadily during the previous quarter, mainly driven by autos and home appliances, and we expect order growth to remain stable into the 4Q. Meanwhile, larger steel enterprises have particularly expressed that sales generated from property developers have remained stable albeit certain furnaces have been closed down on government's order and believe the chances for such capacity to resume production will be slim. Hence, we foresee steel prices to be maintained on an uptrend with steel mills' margins to remain stable in the 2H of the year.

Positive profit alert from Angang. Although Angang's profit alert for a turnaround to a RMB1,823mn net profit for the interim implies a quarterly decrease to RMB753mn, mainly due to the lower flat steel product prices, the overall net profit results are ahead of both market and our expectations. Moreover, we believe Magang will also benefit in terms of margin expansion as long as steel product prices continue to rise in the period.

Undemanding valuation at 0.8x FY17E PBR for Angang and 1.0x for Magang. We reiterate our BUY rating on Angang with PT maintained at HKD6.50, pegging on FY17E PBR of 0.9x. Meanwhile, we will also maintain our BUY rating on Magang but revise up our PT to HKD4.0 (from HKD3.5), pegging on FY17E PBR of 1.10x (prior 1.0x). Magang remains to be our preferred sector stock pick.

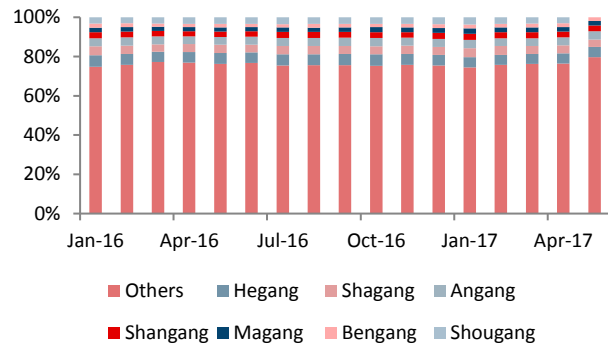
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Figure 1: China crude steel daily production



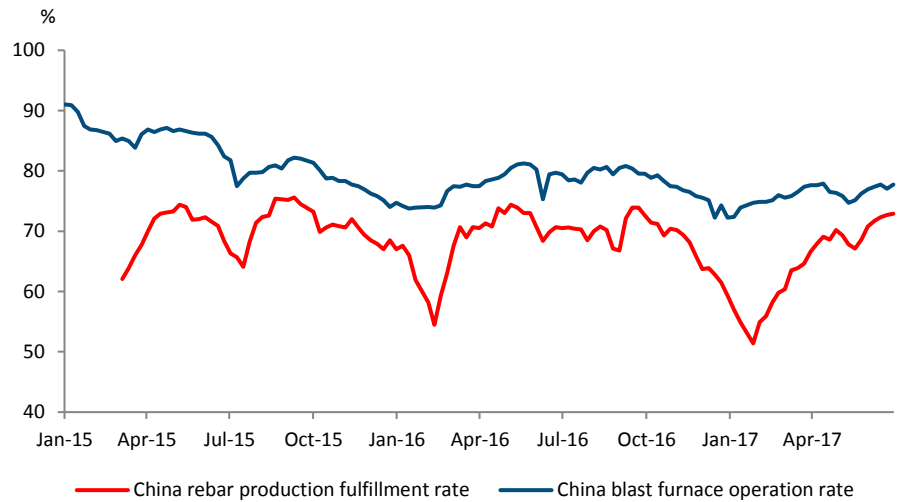
Source: Wind

Figure 2: China crude steel production by producers



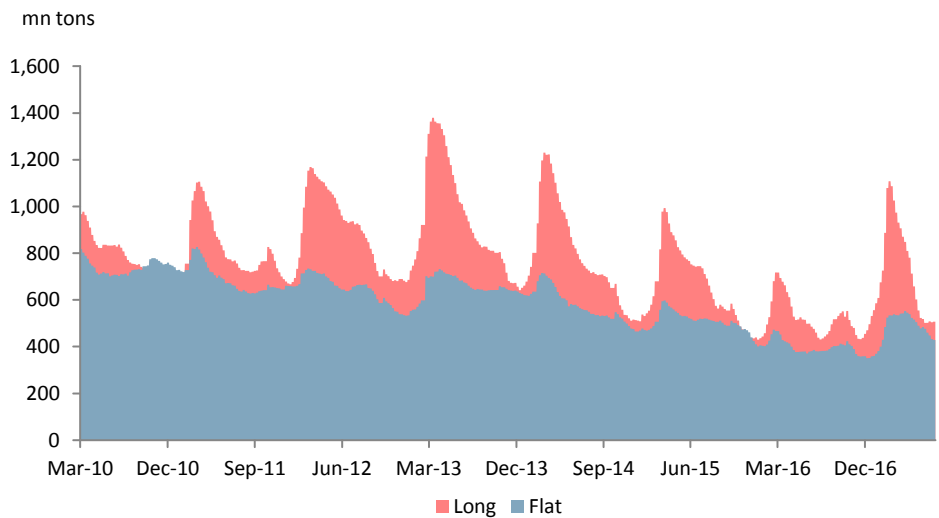
Source: Wind

Figure 3: Capacity utilisation

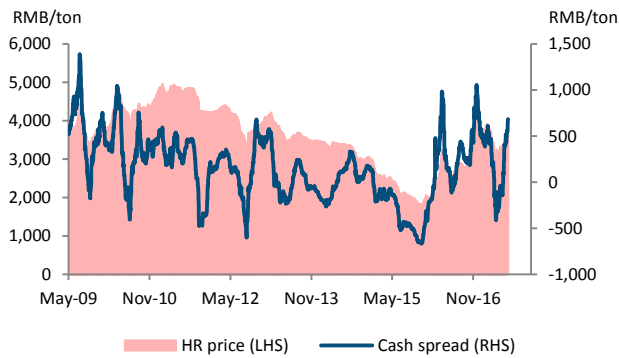
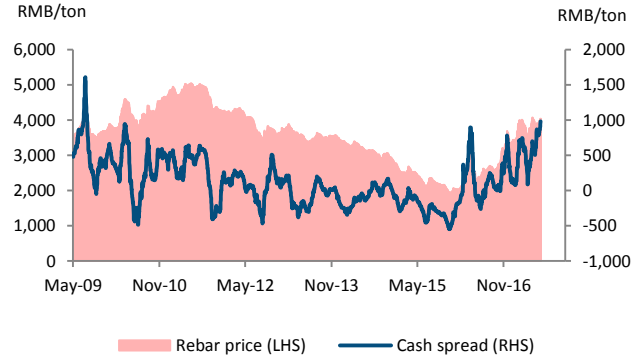


Source: Wind

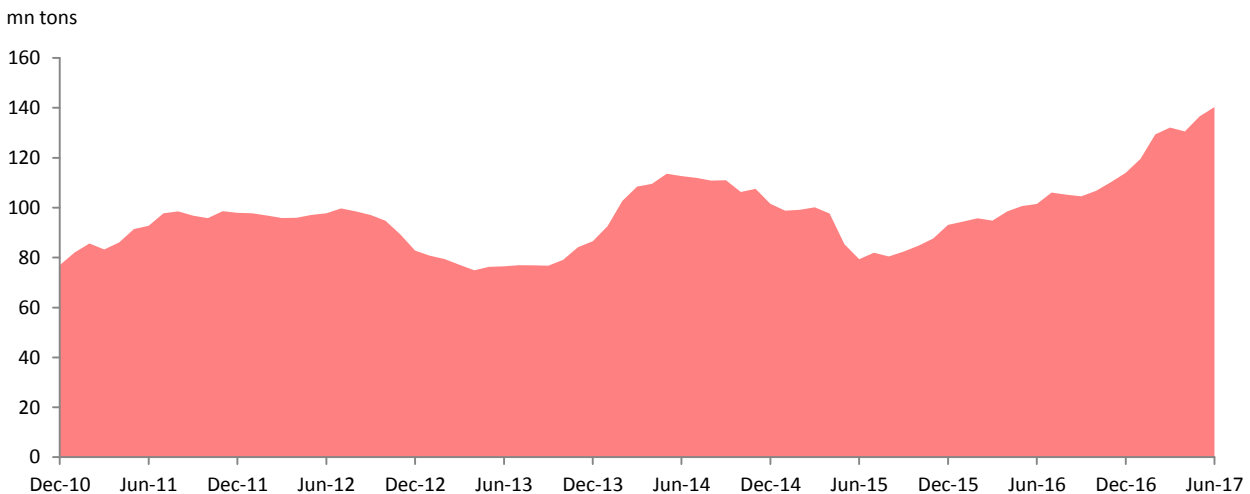
Figure 4: China steel products inventory



Source: Wind

Figure 5: China hot-rolled price and spread

Figure 6: China rebar price and spread


Source: Bloomberg, CSCI Research estimates

Figure 7: China iron ore inventory at ports


Source: Wind

Figure 8: China steel prices

	Unit	2012	2013	2014	2015	2016	1Q17	2Q17	3Q17	2017YTD
Hot rolled steel	RMB/ton	3,999	3,681	3,269	2,244	2,763	3,743	3,238	3,654	3,496
Rebar steel price	RMB/ton	3,930	3,573	3,354	2,317	2,628	3,701	3,802	3,982	3,769
Import Fe62	RMB/ton	922	952	670	425	468	692	504	506	1,056
Hebei iron ore	RMB/ton	1,092	1,077	860	580	584	788	659	642	716
QHD coal	RMB/ton	702	582	512	405	467	617	597	600	607
Coke	RMB/ton	1,750	1,465	1,084	872	1,281	2,032	1,856	1,810	1,932

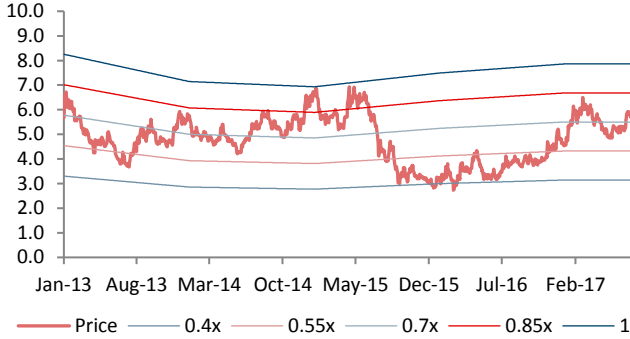
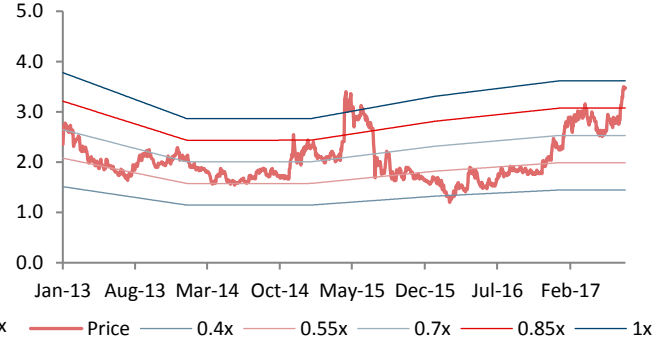
Source: Bloomberg

Figure 9: Major assumptions

	Angang			Magang		
	2017E	2018E	2019E	2017E	2018E	2019E
Sales volume	19,857	19,857	19,857	18,000	18,000	18,000
Average price	2,989	3,010	3,010	2,891	2,920	2,920
Revenue	63,820	64,237	64,237	55,235	55,755	55,755
Gross profit	9,552	9,967	9,967	7,440	7,952	7,952
Gross margin	15.0	15.5	15.5	13.5	14.3	14.3
EBIT	4,571	4,954	4,954	3,815	4,283	4,281
EBIT margin	7.2	7.7	7.7	6.9	7.7	7.7

Source: CSCI Research estimates

Valuation

Figure 10: Angang's PBR band

Figure 11: Magang's PBR band


Source: Bloomberg, CSCI Research estimates

Source: Bloomberg, CSCI Research estimates

Figure 12: Peer valuation

Company	Ticker	Ccy	Close		Mkt cap		PER (x)		EPS Growth (%)		PBR (x)		ROE (%)		EV/EBITDA (x)		Yield (%)		Net debt / Equity (%)	
			(Local\$)	(US\$b)	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E	2017E	2018E
Glencore	805 HK	HKD	319	58.8	12.7	14.3	179.1	(10.9)	12	12	10.7	9.2	6.4	6.6	0.4	57.1				
CMoC	3993 HK	HKD	3.7	13.9	29.5	23.6	98.2	22.5	2.2	2.1	8.5	9.6	17.5	13.2	14	N/A				
Zijin	2899 HK	HKD	2.5	10.9	12.5	11.2	813	14.4	15	14	12.3	12.5	10.5	9.3	3.7	1016				
CHALCO	2600 HK	HKD	4.4	10.3	22.4	16.5	517.9	32.9	14	13	6.5	7.9	10.2	9.1	0.3	162.5				
Rusal	486 HK	HKD	4.1	8.0	6.4	5.6	69.4	13.3	18	14	315	27.5	8.9	8.3	0.4	163.5				
Jiangxi Copper	358 HK	HKD	12.7	7.5	19.2	17.5	64.2	9.5	0.8	0.8	4.3	4.8	10.8	9.8	19	110				
Angang	347 HK	HKD	6.1	6.3	15.2	12.5	56.6	22.3	0.8	0.8	5.3	6.2	8.4	7.8	15	40.8				
Magang	323 HK	HKD	3.6	4.5	10.5	10.3	96.0	3.4	11	10	10.2	9.8	7.4	7.3	10	60.3				
MMG	1208 HK	HKD	2.9	2.9	7.9	6.8	1433.3	17.4	10.4	6.0	87.6	115	7.7	7.8	-	477.2				
Zhaojin	1818 HK	HKD	6.3	2.6	28.7	24.3	6.3	20.3	14	14	5.4	5.9	15.3	11.1	11	80.2				
CGI	2099 HK	HKD	115	0.6	50.6	19.8	N/A	155.2	0.4	0.4	0.8	2.0	N/A	N/A	N/A	N/A				
CNF	1258 HK	HKD	12	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				
CGNM	164 HK	HKD	0.6	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	0.8	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					19.6	14.8	260.2	27.3	2.1	16	16.7	20.6	10.3	9.6	12	128.2				

Source: Bloomberg

Figure 13: 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	63,820	64,237	64,237	EBIT	(2,410)	2,907	4,571	4,954	4,954
COGS	(49,693)	(50,457)	(54,268)	(54,270)	(54,270)	Depreciation & amortisation	3,925	3,924	3,667	3,495	3,335
Gross profit	3,066	7,425	9,552	9,967	9,967	Net interest	1,346	1,286	898	759	619
Selling expenses	(2,311)	(1,928)	(2,126)	(2,140)	(2,140)	Taxes paid	(837)	(5)	(1,101)	(1,258)	(1,300)
General and administrative	(1,808)	(1,626)	(1,793)	(1,805)	(1,805)	Changes in working capital	4,407	(1,287)	(250)	(71)	-
Other opex	(1,704)	(1,300)	(1,433)	(1,443)	(1,443)	Others	(1,294)	(7,673)	(1,797)	(1,520)	(1,239)
Operating profit	(2,757)	2,571	4,200	4,580	4,580	Cash flow from operations	5,137	(848)	5,987	6,359	6,368
Net interest expense	(1,346)	(1,286)	(898)	(759)	(619)	Capex	(3,807)	(1,300)	(1,300)	(1,300)	(1,300)
JVs and associates	340	335	369	372	372	Acquisitions	(70)	-	-	-	-
Pretax profit	(3,763)	1,620	3,672	4,193	4,333	Disposals	4	-	-	-	-
Taxation	(837)	(5)	(1,101)	(1,258)	(1,300)	Others	145	-	-	-	-
Minority interests	7	1	2	2	2	Cash flow from investing	(2,728)	(1,300)	(1,300)	(1,300)	(1,300)
Net profit	(4,593)	1,616	2,572	2,937	3,035	Dividends	(1,782)	(485)	(772)	(881)	(911)
Net profit (adjusted)	(4,593)	1,616	2,572	2,937	3,035	Issue of shares	-	-	-	-	-
EBIT	(2,410)	2,907	4,571	4,954	4,954	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	1,515	6,831	8,238	8,449	8,289	Cash flow from financing	(516)	515	(3,772)	(3,881)	(3,911)
Basic EPS (RMB)	(0.63)	0.22	0.36	0.41	0.42	Change in cash	1,893	(1,633)	915	1,177	1,157
Diluted EPS (RMB)	(0.63)	0.22	0.36	0.41	0.42	Free cash flow	1,330	(2,148)	4,687	5,059	5,068
DPS (RMB)	-	0.07	0.11	0.12	0.13						

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	2,883	4,060	5,218	Operating ratios					
Short term investments	-	-	-	-	-	Gross margin	5.8	12.8	15.0	15.5	15.5
Accounts receivables	8,311	8,352	9,186	9,246	9,246	EBITDA margin (%)	2.9	11.8	12.9	13.2	12.9
Inventory	8,008	10,466	9,933	9,933	9,933	Effective tax rate (%)	(22.2)	0.3	30.0	30.0	30.0
Other current assets	3,675	4,890	4,638	4,649	4,649	Revenue growth (%)	-	9.7	10.3	0.7	-
Total current assets	23,595	25,676	26,640	27,889	29,046	Net income growth (%)	-	-	59.1	14.2	3.4
PP&E	51,014	49,065	46,698	44,503	42,468	EPS growth adj (%)	-	-	59.1	14.2	3.4
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	5.5	6.0	6.0
Total long term assets	65,001	62,393	60,026	57,831	55,796	ROCE (%)	(6.0)	5.0	8.0	8.5	8.3
TOTAL ASSETS	88,596	88,069	86,666	85,720	84,842	Asset turnover (x)	0.6	0.7	0.7	0.7	0.8
Short term debt	16,319	18,995	16,639	14,284	11,928	Op cash / EBIT (x)	(19)	(0.3)	14	14	14
Accounts payables	5,799	10,055	8,525	8,525	8,525	Depreciation / CAPEX (x)	10	3.0	2.8	2.7	2.6
Other current liabilities	20,886	7,739	9,068	9,068	9,068	Accounts receivable days	68.8	62.2	60.5	62.0	62.2
Total current liabilities	43,004	36,789	34,232	31,877	29,521	Accounts payable days	68.0	78.6	79.3	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	39.3	29.1	19.7
Bonds payable	-	3,944	3,944	3,944	3,944	Net debt / EBITDA (x)	9.0	3.3	2.2	1.7	1.2
Other long term liabilities	-	-	-	-	-	Interest cover (x)	(2.0)	2.0	4.7	6.0	7.4
Total long term liabilities	1,911	5,992	5,348	4,703	4,059	Current ratio (x)	0.5	0.7	0.8	0.9	1.0
TOTAL LIABILITIES	44,915	42,781	39,580	36,580	33,580	Valuation					
Shareholders' funds	43,274	44,882	46,682	48,737	50,862	PER (x)	-	23.7	14.9	13.0	12.6
Minority interests	407	406	404	403	401	EV/EBITDA (x)	44.8	10.5	8.2	7.5	7.2
TOTAL LIAB AND EQUITY	88,596	88,069	86,666	85,720	84,842	PBR (x)	0.9	0.8	0.8	0.8	0.7
Net cash / (debt)	(13,680)	(22,267)	(18,352)	(14,175)	(10,017)	Dividend yield (%)	-	13	2.0	2.3	2.4

Source: Company, Bloomberg, CSCI Research estimates

Figure 14: 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	55,235	55,755	55,755	EBIT	(3,613)	2,134	3,815	4,283	4,281
COGS	(45,690)	(42,990)	(47,795)	(47,804)	(47,804)	Depreciation & amortisation	3,380	3,569	3,657	3,594	3,538
Gross profit	(581)	5,286	7,440	7,952	7,952	Net interest	813	794	763	637	534
Selling expenses	(636)	(695)	(795)	(802)	(802)	Taxes paid	(378)	(112)	(776)	(927)	(953)
General and administrative	(1,539)	(1,780)	(2,037)	(2,056)	(2,056)	Changes in working capital	5,225	(4,747)	1,944	(53)	-
Other opex	(1619)	(881)	(1,008)	(1,018)	(1,018)	Others	438	531	(1,474)	(123)	(1,004)
Operating profit	(4,375)	1,929	3,600	4,075	4,075	Cash flow from operations	5,865	2,169	7,929	6,321	6,396
Net interest expense	(813)	(794)	(763)	(637)	(534)	Capex	(2,846)	(3,000)	(3,000)	(3,000)	(3,000)
JVs and associates	461	233	266	269	269	Acquisitions	(5,405)	-	-	-	-
Pretax profit	(4,727)	1,369	3,104	3,707	3,811	Disposals	4,324	-	-	-	-
Taxation	(378)	(112)	(776)	(927)	(953)	Others	306	-	-	-	-
Minority interests	300	(28)	(52)	(62)	(63)	Cash flow from investing	(3,621)	(3,000)	(3,000)	(3,000)	(3,000)
Net profit	(4,804)	1,229	2,276	2,719	2,795	Dividends	(1081)	-	-	-	-
Net profit (adjusted)	(4,804)	1,229	2,276	2,719	2,795	Issue of shares	-	-	-	-	-
EBIT	(3,613)	2,134	3,815	4,283	4,281	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	(233)	5,704	7,472	7,877	7,819	Cash flow from financing	(1,555)	1,000	(4,000)	(2,000)	(3,000)
Basic EPS (RMB)	(0.62)	0.16	0.30	0.35	0.36	Change in cash	689	169	929	1,321	396
Diluted EPS (RMB)	(0.62)	0.16	0.30	0.35	0.36	Free cash flow	3,019	(831)	4,929	3,321	3,396
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	6,241	7,562	7,958	Operating ratios					
Short term investments	-	-	-	-	-	Gross margin	(13)	10.9	13.5	14.3	14.3
Accounts receivables	4,689	3,608	4,747	4,792	4,792	EBITDA margin (%)	(0.5)	11.8	13.5	14.1	14.0
Inventory	6,018	10,548	9,206	9,207	9,207	Effective tax rate (%)	(8.0)	8.2	25.0	25.0	25.0
Other current assets	4,310	4,950	5,038	5,047	5,047	Revenue growth (%)	-	7.0	14.4	0.9	-
Total current assets	20,160	24,418	25,232	26,608	27,003	Net income growth (%)	-	(25.6)	85.2	19.4	2.8
PP&E	34,605	35,523	34,866	34,272	33,734	EPS growth adj (%)	-	(25.6)	85.2	19.4	2.8
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	10.3	11.0	10.1
Total long term assets	42,294	41,827	41,171	40,576	40,039	ROCE (%)	(13.4)	5.9	10.9	11.7	11.2
TOTAL ASSETS	62,454	66,246	66,403	67,184	67,042	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)	(13)	1.1	2.2	1.6	1.6
Accounts payables	6,145	6,669	7,121	7,121	7,121	Depreciation / CAPEX (x)	12	12	12	12	12
Other current liabilities	16,795	19,939	21,316	21,316	21,316	Accounts receivable days	60.0	37.6	33.6	37.5	37.6
Total current liabilities	29,731	33,550	33,276	32,225	30,647	Accounts payable days	92.2	93.2	86.2	93.2	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	26.6	10.2	(3.1)
Bonds payable	3,980	3,988	3,988	3,988	3,988	Net debt / EBITDA (x)	(52.7)	1.9	0.8	0.3	(0.1)
Other long term liabilities	-	-	-	-	-	Interest cover (x)	(5.4)	2.4	4.7	6.4	7.6
Total long term liabilities	11,982	10,615	8,719	7,770	6,348	Current ratio (x)	0.7	0.7	0.8	0.8	0.9
TOTAL LIABILITIES	41,713	44,165	41,994	39,995	36,995	Valuation					
Shareholders' funds	18,456	19,764	22,041	24,759	27,554	PER (x)	(5.0)	19.7	10.6	8.9	8.7
Minority interests	2,286	2,316	2,368	2,429	2,493	EV/EBITDA (x)	(10.7)	8.5	5.8	5.1	4.7
TOTAL LIAB AND EQUITY	62,454	66,246	66,403	67,184	67,042	PBR (x)	12	1.1	1.0	0.9	0.8
Net cash / (debt)	(12,283)	(10,782)	(5,853)	(2,532)	864	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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