

Equities

28 May 2012 | 9 pages

PRC Steel

Alert: Vicious Cycle – the More Losses, the More Stimuli

Building the ghost city of steel on flowing sand – Baosteel's Zhanjaing project with crude capacity of 10 Mt and WISCO's Fangchenggang project with crude capacity of 9.2 Mt got approvals from NDRC, as the government would like to speed up the construction of key projects in order to cushion against the economic downturn. We regard this movement as unwise.

Capacity has been expanding regardless of NDRC approval – NDRC officially stopped approving new capacities by 09 when crude capacity totaled 718 Mt. Additional capacity of 50 Mt launched in 2010. Another 86 Mt kicked off in 2011, replacing small furnaces of 20 Mt, hence a net increase of 66 Mt. Referring to our channel check, more than 40 furnaces under construction could be put into production in 12E, estimated as 50 Mt. Total capacity should reach 884 Mt by the end of 12E, whilst demand forecasted as 712 Mt only.

Front-running happened before the approval got finalized – Baosteel and WISCO were building infrastructure in the past two years. The final approval gave a green light to install equipment, which should compete in 12 months.

Expanded capacity from 6 Mt each to 10 Mt and 9.2 Mt respectively – The two projects were originally planed as 6 Mt each. Local governments took the chance of NDRC eagerly opening doors for project approval, and exaggerated the capacity.

Excessive capacity becomes more excessive – We revise up 13E capacity from 896 Mt to 903 Mt, to reflect the expanded capacity for Zhanjiang & Fangchenggang. The overly supplied industry is worsening further.

Destroying value – Large & medium-sized steel mills as a group posted 2.4% pre-tax margin in 2011 & struggled on loss making in 1Q12. They just turned around from late Mar. Spread gain from steel price over ore price has diminished from May. We expect losses to occur again and production cuts to take place soon.

Baosteel delivered 6% ROE in 11, the highest across the industry – Baosteel generated net profit of Rmb 7.4bn in 11, almost 30% of the total for the industry. The best in the industry, Baosteel delivered 6% ROE only, lower than 1-year borrowing cost during the period. Angang reported ROE of -4.1% and Magang 0.3%.

Vicious cycle – the more losses, the more stimuli on capacity – Pre-tax margin has fallen from 7.3% in 07 to 2.4% in 11, and is highly likely to be in the red in 12E. New capacity approved in Zhajiang & Fangchenggang as part of the stimulus should dampen the outlook further. Sell Angang (0347.HK; HK\$4.29; 3H) (TP HK\$4.24) & Neutral Magang (0323.HK; HK\$1.84; 2H) (TP HK\$2.5).

■ Industry Overview

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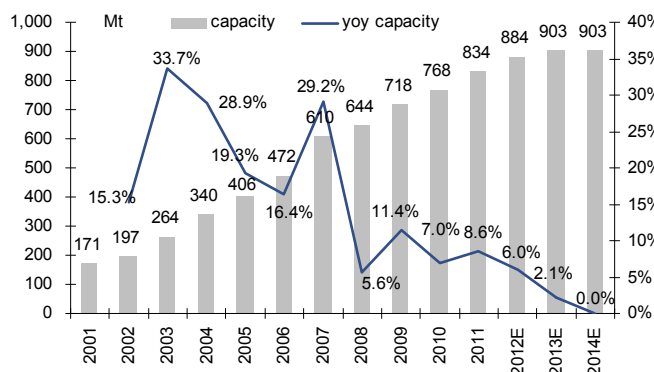
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Figure 1. Crude steel capacity forecast



Source: Citi Investment Research and Analysis, Industry Authorities

Figure 2. Crude steel demand forecast

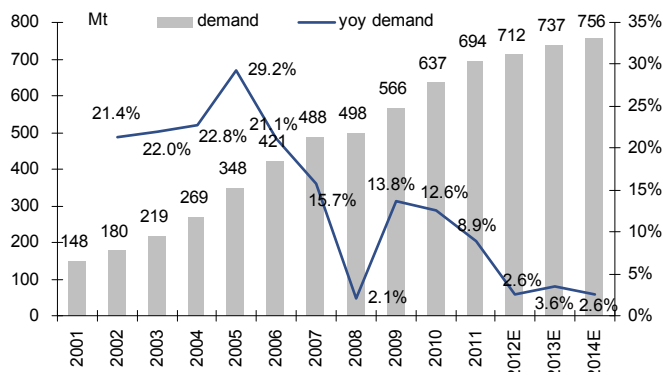
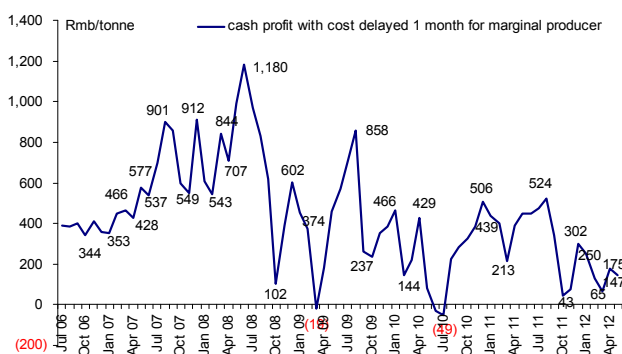


Figure 3. Cash profit for a mill selling rebar spot & buying materials spot



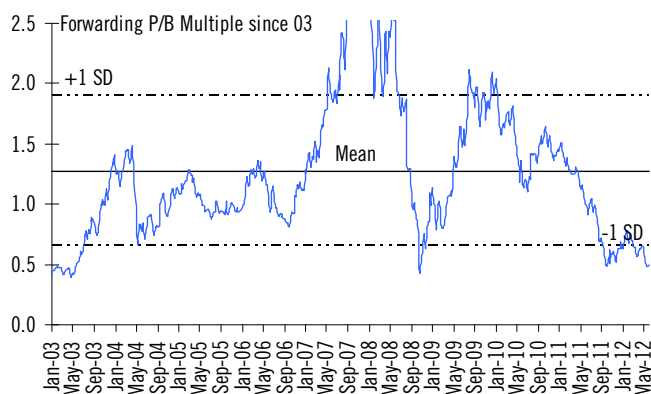
Source: Citi Investment Research and Analysis

Figure 4. Large & medium sized steel mills' key financials

Rmb Bil	Revenue	Pre-tax profit	Pre-tax margin
2002	444	23	5.3%
2003	633	47	7.4%
2004	1,005	81	8.1%
2005	1,175	77	6.5%
2006	1,332	90	6.8%
2007	1,991	145	7.3%
2008	2,565	85	3.3%
2009	2,248	55	2.5%
2010	3,087	90	2.9%
2011	3,619	88	2.4%
2012 YTD	864	(1)	-0.1%

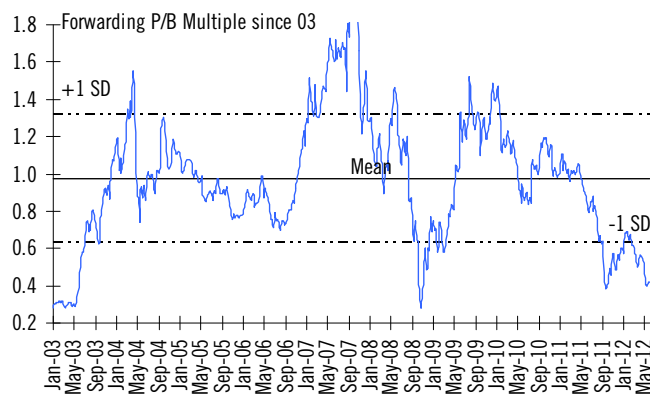
Source: Citi Investment Research and Analysis, CISA

Figure 5. Angang 12M forward PB chart



Source: Citi Investment Research and Analysis

Figure 6. Magang 12M forward PB chart



Source: Citi Investment Research and Analysis

Angang Steel

Valuation

Our target price for Angang of HK\$4.24/s is set at 0.48x FY12E PB, 1SD below the historical avg PB since 2001. The steel industry is bottoming with a short profitable window in 2Q. However, the sector remains overly supplied with high uncertainty on sustainable earnings. Trading history on book value provides the most valid reference for valuation, in our view. We use 1SD below average historical PB to reflect concerns of a further de-rating. If Angang makes losses for two consecutive years, it should get prefixed as a ST stock in the A-share market, which should trigger a de-rating in the H-share market.

Risks

We assign a High Risk rating to Angang to reflect the weak fundamentals of the steel sector. The key upside risks to our target price and investment thesis are: 1) Improvement in sales/production for autos and other downstream sectors; 2) Oriented silicon may drive up profit margin if it goes into mass production; 3) Cost control may be better than expected. If any of these risk factors has a greater impact than we anticipate, the share price could exceed our target price.

Maanshan Iron and Steel

Valuation

Our target price is set at HK\$2.5/sh. We value the stock at 0.54x 12E PB, based on 1SD below average PB since 2002. We switch from EV/t of replacement cost to PB valuation as we think the industry is bottoming with a short profitability window in 2Q, though earnings sustainability is uncertain. We feel that the trading history of book value provides a better reference for valuation. PB valuation has historically worked well at this stage of the cycle. We use 1SD below average PB because earnings sustainability is in doubt.

Risks

We assign a High Risk rating to Magang to reflect uncertainties related to the steel sector. Key downside risks to our investment thesis on Magang are: 1) Downstream demand could worsen; and 2) Cost management may not be efficient as expected. The key upside risks to our investment thesis on Magang are: 1) If it achieves a break-through for the high-speed-wheel steel ahead of schedule, the stock could rerate; 2) Spot price for steel may spike up if downstream sector demand is recovering better than expected. If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price. Conversely, if the impacts of any of these upside risks are greater than we anticipate, the stock could exceed our target price.

Appendix A-1

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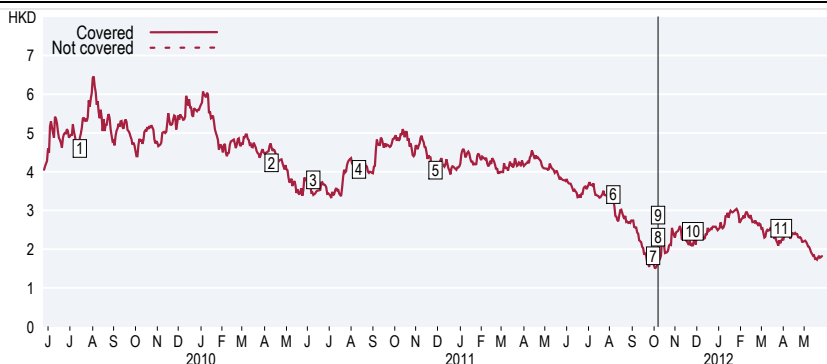
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Maanshan Iron and Steel (0323.HK)

Ratings and Target Price History

Fundamental Research

Analyst: Scarlett Y Chen, CFA
Covered since April 12 2010



	Date	Rating	Target Price	Closing Price
1	15-Jul-09	3M	*4.20	4.87
2	12-Apr-10	3M	*3.63	4.62
3	9-Jun-10	3M	*2.75	3.40
4	12-Aug-10	*1M	*4.86	4.06

* Indicates change

	Date	Rating	Target Price	Closing Price
5	29-Nov-10	*3M	*4.23	4.07
6	5-Aug-11	*2M	*3.39	3.24
7	30-Sep-11	*3M	*1.23	1.71
8	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	*3	1.23	1.78
10	25-Nov-11	*1H	*6.40	2.08
11	29-Mar-12	*2H	*2.50	2.22

Rating/target price changes above reflect Eastern Standard Time

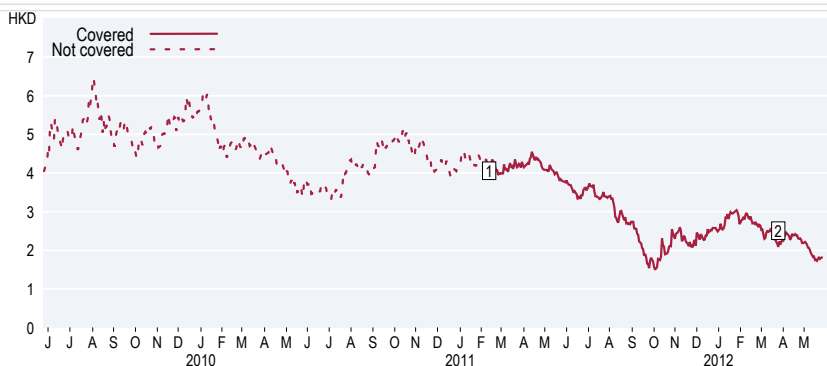
Maanshan Iron and Steel (0323.HK)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Scarlett Y Chen, CFA
Covered since April 12 2010



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	4.17

* Indicates change

	Date	Rating	Target Price	Closing Price
2	25-Mar-12	*REM LP	-	2.17

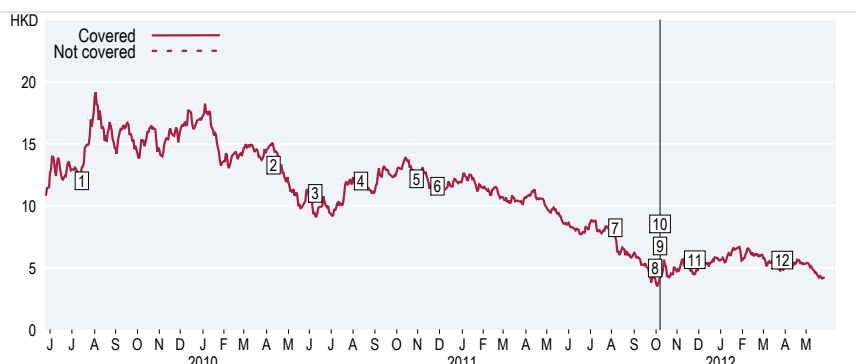
Rating/target price changes above reflect Eastern Standard Time

Angang Steel (0347.HK)

Ratings and Target Price History

Fundamental Research

Analyst: Scarlett Y Chen, CFA
Covered since April 12 2010



	Date	Rating	Target Price	Closing Price
1	15-Jul-09	*1M	*15.50	13.10
2	12-Apr-10	*2M	*16.20	14.72
3	9-Jun-10	*3M	*7.89	9.20
4	12-Aug-10	*2M	*12.90	11.40

* Indicates change

	Date	Rating	Target Price	Closing Price
5	29-Oct-10	2M	*13.79	12.18
6	29-Nov-10	*3M	*11.99	11.18
7	5-Aug-11	3M	*7.49	7.47
8	30-Sep-11	3M	*4.04	4.12

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	Stock rating system changed		
10	7-Oct-11	*1	4.04	4.40
11	25-Nov-11	*2H	*5.51	4.44
12	28-Mar-12	*3H	*4.24	4.88

Rating/target price changes above reflect Eastern Standard Time

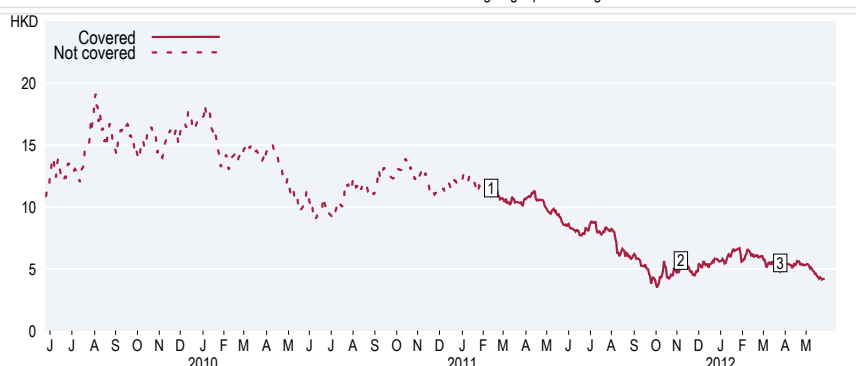
Angang Steel (0347.HK)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Scarlett Y Chen, CFA
Covered since April 12 2010



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	10.88

* Indicates change

	Date	Rating	Target Price	Closing Price
2	7-Nov-11	*REM LP	-	5.32

	Date	Rating	Target Price	Closing Price
3	25-Mar-12	*ADD LP	-	4.85

Rating/target price changes above reflect Eastern Standard Time

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