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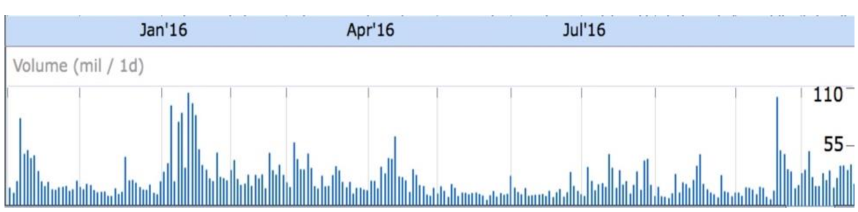
Angang Steel Company Limited– 000898.SZ

Executive Summary

Strong steel price expected in China, with cost control advantages, make Angang highly attractive. Recommendation is a BUY given the following:

- **Downstream industries show growth potential and increasing demand for iron and steel**
- **The pattern of strong steel and weak iron ore prices drives the significant improvement of Angang steel**
- **Increase in steel prices index indicates rising output price of iron and steel**
- **The ability to merge and acquire other companies will improve the company's strength**



Source: Google Finance

Rating	**BUY**
Target price	**RMB 5.31**
Current price	**RMB4.56**
Upside	**16.44%**

Analysts' Suggestion	**Oct 2016**
Buy	**3**
Outperform	**13**
Hold	**1**
Underperform	**0**
Sell	**0**

Stock Information	
Previous Close	**4.56**
Volume	**18.7M**
Day High/Low	**4.56/4.61**
52 wk High/Low	**3.62/5.45**
Market Cap	**28.04B**

30 Oct 2016

Authors:

Alex Lau, Fan Gao, Minyu Zhang, Yiwei Duan, Zongheng Xiao

Who is Angang Steel Company Limited?

The company was formerly known as Angang New Steel Company Limited and changed its name to Angang Steel Company Limited in June 2006. The company was founded in 1997 and is headquartered in Anshan, the People's Republic of China. Angang Steel Company Limited is a subsidiary of Anshan Iron & Steel Group Complex. Angang Steel Company Limited engages in producing, processing, and selling of steel products in the People's Republic of China. The company engages in ferrous metal smelting activities and produces various forms of steel sheets and plates, wire rods, heavy sections, and seamless steel pipes. In addition, it sells their products, domestically and internationally to various industries, such as light and heavy industries, and construction and infrastructure.

Key Points

1. Downstream industries show growth potential and increasing demand for iron and steel

Infrastructure and property investment are increasing in the third quarter, leading to high demand for iron and steel constructional materials. Investment in real estate development has a reported 2.9% increase in July and August 2016, compared with the same period last year. The Chinese economy has been relatively stable since the beginning of 2016. Demand from infrastructure also shows positive prospects. As a result, the number of orders made by construction companies is higher than expected.

Manufacturing, especially auto mobile industry, is another reason for the booming needs for iron and steel. The deduction of tax on automobile purchases (effective from October 2015) acts as a strong stimulus of auto mobile industry in the first half of 2016 till now. Third quarter automobile production responds to policy changes by showing a 27.93% increase compared with last year. Excavating machines show an impressive 71.4% growth in September, contributing to the higher demand of iron and steel as well.

2. The pattern of strong steel and weak iron ore prices drives the significant improvement of Angang steel

From the cost side, based on the output capacity of iron ore has been relatively decreased, the performance of iron ore in the 3rd quarter has been relatively weak. The price of imported iron ores has decreased by 8.75% year on year. Therefore, the steel performed better than the iron ores, which greatly improved the profits of the company. In addition, the steel industry has been sluggish in recent years, especially with huge losses in 2015. Angang steel has put many efforts to cut down the cost and promote working efficiency. On one hand, they strengthened the structure adjustment and enhanced the promotion of high value-add and high margin products. On the other hand, Angang steel has adapted a purchasing process to reduce the cost of energy.

3. Increase in steel prices index indicates rising output price of iron and steel

In the second quarter, the net profit of Angang is 249% higher than the first. There are several major reasons. Steel Price Index increased significantly by 22.5% compared with the first quarter. In the third quarter, the steel prices remain strong. During Q3, price increased 20.63% compared to last year. We are expecting the Price Index to continue to show an upward trend as the demand for steel and Iron is supported by infrastructure, property and manufacturing industry. On the other hand, iron ore prices (key raw material) are did not perform as strong in the second quarter, showing only a 13.04% increase. Angang was able to capture a higher margin from its production. In addition, the production level of Angang is 2.99% higher than last year, contributing to the increased revenue.

4. The ability to merge and acquire other companies will improve the company's strength

Angang steel has the power to integrate the regional companies during the state-owned enterprise reform. We should focus on the restructuring of Angang Steel, and Benxi Iron and steel. At present, Angang Steel is experiencing a critical period of capacity tightening. Hence, merger and acquisition will be the trend and tide in this industry. Angang steel is capable of integrating the iron and steel enterprises in Northeast China during the state-owned enterprise reform. Moreover, the probability to integrate the two groups is very high. In addition, in April 2016, Angang formed a joint venture between Kobe Steel, Ltd. and China's Angang Steel.

Competitor Analysis

We believe at the end of 2016, Angang Steel will have a positive growth in revenue. In addition to that, Angang steel has performed well in reducing operating cost resulting from the special measures taken by the management team from the start of the year. These measures will be continued and further reduce the operating cost. As a result, Angang Steel reached a high-profit margin of 13% by Q3, significantly higher than the industry average. Baoshan Iron and Steel also performed similarly to Angang Steel, if not better in some aspects. However, Baoshan will face huge risks after announcing the acquisition of Wuhan Iron and Steel, which perform badly in the recent years.

Date	30-Sep	30-Jun	31-Mar	31-Dec	30-Sep	30-Jun	31-Mar	31-Dec
	Baoshan Iron&Steel (600019)				**Wuhan Iron&Steel (600005)**			
Revenue Increase (%)	9.2	-3.4	-14.8	-12.6	-16.4	-26.6	-41.3	-19.9
Operation Cost (%)	87.8	86.0	87.5	91.1	92.2	91.6	101.5	93.6
Profit Margin (%)	11.9	13.6	12.1	8.6	7.6	8.2	-1.9	6.1
Net Profit Increase (%)	151.0	9.9	-6.0	-88.3	-48.9	-93.0	-681.1	-224.6
	XINXING PIPES (000778)				**Angang Steel (000898)**			
Revenue Increase (%)	0.4	-14.8	-17.7	-22.3	-1.3	-12.3	-24.6	-28.7
Operation Cost (%)	94.6	95.0	95.4	96.5	86.5	87.4	93.0	93.8
Profit Margin (%)	5.3	4.8	4.4	3.4	13.0	12.1	6.5	5.8
Net Profit Increase (%)	-27.2	-22.2	-16.1	-65.0	230.3	86.7	-3516	-597.8
	Hesteel (000709)				**Taigang Stainless Steel (000825)**			
Revenue Increase (%)	-3.4	-10.7	-18.8	-25.6	-23.1	-29.1	-33.3	-21.7
Operation Cost (%)	87.2	87.8	89.5	86.7	85.3	85.1	90.5	95.3
Profit Margin (%)	12.6	12.1	10.5	13.1	14.3	14.4	9.1	4.5
Net Profit Increase (%)	118.7	23.1	-56.2	-44.0	N/A	829.4	-47596	-1478

P/B Ratio

Angang Steel, similar to the whole industry, has a lower P/B ratio than other industries. This indicates the stock may be undervalued. It is the right time to buy the stock of steel companies, especially when the companies have strong chance of good profitability.

Valuation

In order to evaluate the company's stock price, we built a FCFE Two stage model based on a conservative forecast of rapid growth of EPS of 18.7% in the first three years (due to the recovery of steel industry and successful implementation of the company's cost reduction plan) and stabilized the growth rate of at 3% after three years. The cost of equity is 5.75% (using the CAPM model to calculate equity cost of capital Re = Rf + (Rm - Rf) * Beta). We assume the debt structure and capital spending remains stable in the future and equity beta would not change. Using these parameters in FCFE Model Two Stage Model, there is an 16.44% upside.

Estimated FCFE per Share

	2015A	2016E	2017E	2018E	2019E
Earnings	-0.64	0.08	0.10	0.12	0.14
Earnings growth rate			18.70%	18.70%	18.70%
- (CapEx-Depreciation)*(1-DR)	0.00	-0.24	-0.29	-0.34	-0.41
-Chg. Working Capital*(1-DR)	0.00	0.00	0.00	0.00	0.00
Free Cashflow to Equity	-0.63	0.33	0.39	0.46	0.54

FCFE Two Stage Method	
Current Price	4.56
Estimated Price	5.31
Estimated Upside	16.44%

Stabilized Growth Rate

Cost of Equity

	2.00%	**2.50%**	**3.00%**	**3.50%**	**4.00%**
4.75%	4.36	4.82	5.45	6.34	7.69
5.25%	4.30	4.76	5.38	6.26	7.58
5.75%	4.24	4.70	5.31	6.17	7.48
6.25%	4.19	4.64	5.24	6.09	7.38
6.75%	4.14	4.58	5.17	6.01	7.28
	2.00%	**2.50%**	**3.00%**	**3.50%**	**4.00%**
4.75%	-4.48%	5.80%	19.58%	39.03%	68.56%
5.25%	-5.72%	4.42%	18.00%	37.18%	66.29%
5.75%	-6.93%	3.06%	16.46%	35.36%	64.06%
6.25%	-8.12%	1.73%	14.94%	33.58%	61.87%
6.75%	-9.29%	0.42%	13.44%	31.82%	59.72%

FCFE Two Stage Method-Value Per Share

Free Cashflow to Equity at Year 2019	0.54
Cost of Equity	5.75%
Growth Rate after Year 2019	3%
Terminal Value at Year 2019	4.82
Present Value of Terminal Price	4.08
Present Value of FCFE in high growth phase	1.23
Price of the Stock	5.31
Current Price	4.56
Estimated Upside	16.44%

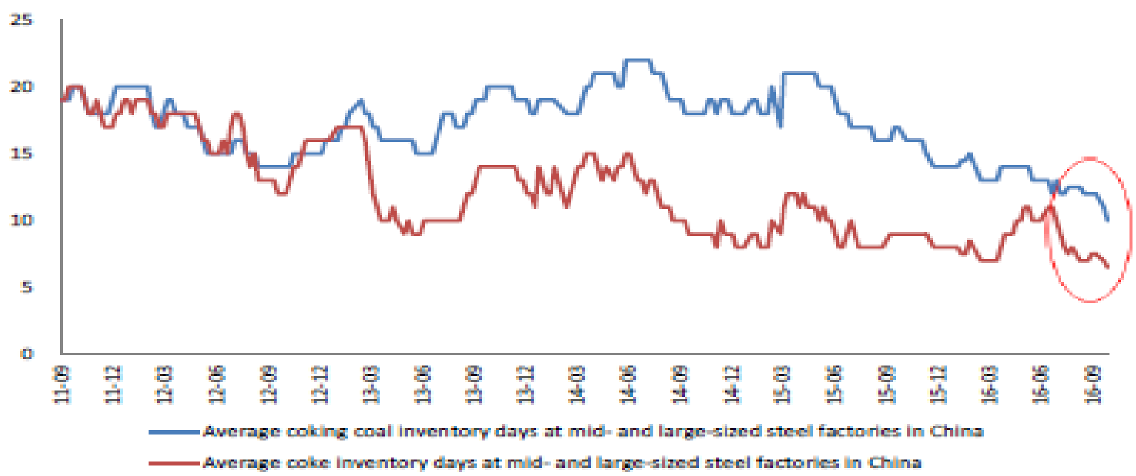
Within our sensitivity analysis, we accounted for both a more optimistic and a less optimistic stabilized growth rate and cost of equity. Assume the cost of equity is same, only if the growth rate decreased to 2%, the return would be negative. In the most optimistic scenario, where the growth rate reaches 4%, the estimated upside is 64%.

Risks

1. Rising input prices

- Coal

There has been a significant rise in both steaming and choking coal prices due to supply shortage in China. This was greatly driven by the steel millers in China that are trying to profit from rises in recent metal prices. Also, the Chinese government has imposed a supply-side structural reform to cut out supply of coal. They have already successfully achieved 80% in reduction targets for the year. If metal prices do not increase in the same manner, it will put pressure on profitability for Angang Steel. According to a research done by Yuanta Securities, coking coal inventory is at its lowest level since 2009.



Source: Yuanta Securities

- Further Yuan Depreciation

Part of Angang Steel's production inputs are imported metals. The Chinese Yuan have been depreciating slowly throughout the whole year which will increase cost of production and squeeze the margin for the company. It is uncertain how this can boost sales, as analysts still view the steel industry being oversupplied.

2. Chinese government plays hard ball on scaling down production

The Chinese government has relaxed supply reforms to the steel industry as metal prices have bounced back significantly this year, even if the medium term target for the industry is to lower supply. It is still uncertain when the government will begin strict reforms and how they will achieve their targets. If Angang Steel is forced to cut supply, then it may restrict their ability to gain full benefit of the high metal prices.

3. Slowing down of users of steel

- Real Estate

There is a possibility that a slowdown in the real estate market may occur in China if the government is tries to stabilize property prices. Approximately half of the steel output in China is used in the real estate industry, so a slowdown will decrease demand for steel products. This may put pressure on revenue for Angang Steel if they cannot diversify their sales stream.

- Infrastructure

The spending of infrastructures, a heavy consumer of steel, by the Chinese government remains stable amid the China-Europe Silk Road Rail. It is uncertain when the slowdown will begin as analysts are aware that the Chinese government cannot maintain current expenditures to support GDP growth for too long.

Performance Stock Picks

Huayuan Property (600743.SH)

The company was established in 1987 and is one of the earliest real estate companies in China. Huayuan focuses on building high quality real estates in Beijing. After its big success in Beijing, Huayuan started to explore new markets such as Xi'an, Changsha and Qingdao. Benefiting from the rising price of real estate in China, Huayuan achieved an excellent financial performance this year. Revenue in quarter 2 increased by 97.9% while net profit increased by 123.77%. The revenue from the sub-market Xi'an is increasing dramatically, reflecting the successful strategy of expanding outside of Beijing.

In the first half year of 2016, Huayuan successfully issued bonds 3 times, totalling 3.5 billion RMB. This will improve the capital structure of company and support the expansive strategy. The land reservation of Huayuan property is kept to the same level as last year as a signal of their cautious attitude to the land market. This is considered a good decision given the current overpriced land market. The price of lands are even higher the price of the real estate around. Huayuan derives their core business in Beijing and Tianjin, and actively explores the second tier cities in china. Therefore, we believe that the company has a sustainable development and will maintain a high profitability.

Fenghuang Holdings(600716.SH)

The company's main business is real estate development and sales, which is divided into residential and commercial real estate development. The main products of company's residential business include high-rise residential, low-density multi-floor residential and villas. The company's business is mainly concentrated in Jiangsu province, and Hefei city. At present, the company has formed a good brand, especially in Jiangsu province. The company will seize the opportunity to enter the pensioner industry, concentrating on building quality retirement community. The main reason why we chose this company was that there were continuously improvements during the reporting period. Due to several good performances of the company's projects, the revenue and net income grew rapidly. Moreover, there is a huge potential market on the pensioner industry in China. The company is experiencing this transformation and the first pensioner project will enter the market by the end of this year. Based on the technical analysis, the company's stock price has been rising and MACD reached a record high. We are expecting an upward trend in the future.

Qingdao Double Star (000599.SZ)

The company has close to a century of history in business development, including their cross-border and cross industry enterprise group. The current Double Star has business over 23 industries such as footwear, tires, clothing, machinery, thermal power and printing. Double Star is the only Chinese rubber enterprise that has four famous brands nationwide. There are three reasons why we chose this company. Firstly, the internal and external demand of tire is improving, driving the company's business growth rate upward. During the first half year, car production in China increased largely which boosted the tire demand. Also, the tire export to US also increased. Secondly, the automobile market is huge, which creates opportunities for company's development. Based on the international market, tire demand has been steadily increasing over the last ten years. Tire replacement market contributes 75% to the total tire market, making the total market less volatile and easier to forecast. Finally, based on the technical indicators, the trading volume recently decreased to the lowest level. We believe there is a low probability that their share price will remain at current suppressed levels, and thus a good time to invest.

Wuxi Boton Technology

Boton is a rubber conveyor belt manufacturer. Interestingly, the company has experienced a significant growth in revenue primarily due to the 70% acquisition of a Hong Kong-based mobile game distributor, Efun. Not only did this acquisition boosted revenue but also allowed Boton to gain access to the overseas game distribution market. In addition, Boton is in the process of finalizing the acquisition of the remaining 30% of Efun.

Even though their core business has declined since 2015 due to the slowing Chinese economy, this acquisition will boost profitability of the group going forward. There are a few games in the pipeline that Efun will be launching. The recent performance of their launches shows that they have been successful especially with a mobile game called "Six Dragons', attracting a turnover close to USD10 million per month, according to a report done by SWS Research. It is expected the new games in the pipeline will continue this success and they are already going through beta tests in 2016 H2. The company will also look to expand their market into Europe and US, which will diversify their revenue streams from the current Asia market focus.

The inclusion of this stock should diversify the Chinese portfolio risk away from China given that the Technology industry have lower correlations to the energy and industrial metals sectors.