

Further steel price cut needed; PO down to NT\$17



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Deteriorating steel industry dynamics

After the in line 23% QoQ price cut for 1Q09, we believe CSC needs to cut its 2Q09 price by a further 15% QoQ (from our previous assumption of 10%) to respond to competitors' more aggressive price cuts due to further steel industry deterioration. We reduce 2009E/10E EPS by 13%/11%. We also cut our PO to NT\$17 (based on 1x P/BV) from NT\$20. Unprecedented losses (we expect three consecutive quarters) may lead CSC to de-rate to trough valuations of 0.8-0.9x.

HRC: Largest price cut to react to China's lower tax

Although the average price cut for 1Q09 of 23% is in line with our forecast, CSC was more aggressive on HRC – cutting by 28%. This additional 5ppt price cut exactly reflects China's removal of 5% export duty on HRC, effective on 1 December. We think CSC will face more pricing pressure from Chinese peers if China raises the rebate on high value products – CRC and galvanized steels.

15% price cut needed for 2Q09E vs. 10% previously

We believe CSC needs to cut 2Q09 steel price more aggressively as: (2) Chinese competitors have recently lowered prices again and (2) downstream customers need to have more competitive costs to sell additional inventory.

Most expensive steelmaker globally

CSC remains the world's most expensive steelmaker, trading at 1.3x 09E P/BV and 18.5x 09E EPS vs. global peer averages of 0.7x and 4.8x. And it's made slow progress on its share buy back. To date, CSC has bought back only one-fifth (622k shares) of the planned 300mn buy back (from 8 October to 7 December).

Estimates (Dec)

(NT\$)	2006A	2007A	2008E	2009E	2010E
Net Income (Adjusted - mn)	39,196	51,264	37,269	14,985	31,417
EPS	3.39	4.39	3.08	1.19	2.49
EPS Change (YoY)	-23.7%	29.3%	-29.9%	-61.3%	109.7%
Dividend / Share	2.78	3.50	2.21	0.857	1.80
Free Cash Flow / Share	3.01	3.08	1.67	0.584	1.30
GDR EPS (US\$)	2.09	2.67	1.84	0.713	1.50
GDR Dividend / Share (US\$)	1.71	2.13	1.33	0.514	1.08

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E	6.34x	4.90x	6.99x	18.07x	8.62x
Dividend Yield	12.93%	16.28%	10.30%	3.98%	8.35%
EV / EBITDA*	5.88x	4.61x	5.07x	10.48x	5.87x
Free Cash Flow Yield*	13.34%	13.81%	7.76%	2.82%	6.28%

* For full definitions of *iQmethod*SM measures, see page 6.

Stock Data

Price (Common / GDR)	NT\$21.50 / US\$12.50
Price Objective	NT\$20.00 to NT\$17.00/ US\$12.10 to US\$10.30
Date Established	26-Nov-2008 / 26-Nov-2008
Investment Opinion	B-3-8 / B-3-8
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	NT\$19.20-NT\$52.82
Market Value (mn)	US\$7,810
Shares Outstanding (mn)	12,115.0 / 605.8
Average Daily Volume	56,825,570
ML Symbol / Exchange	CISEF / TAI
ML Symbol / Exchange	CISXF / OTU
Bloomberg / Reuters	2002 TT / 2002.TW
ROE (2008E)	16.6%
Net Dbt to Eqty (Dec-2007A)	1.9%
Est. 5-Yr EPS / DPS Growth	-3.0% / -3.0%
Free Float	50.0%



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Refer to important disclosures on page 7 to 9. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5.

iQprofileSM China Steel Corporation

Key Income Statement Data (Dec)

(NT\$ Millions)	2006A	2007A	2008E	2009E	2010E
Sales	177,658	207,919	260,236	215,837	237,706
Gross Profit	43,468	55,053	49,077	18,323	38,189
Sell General & Admin Expense	(4,606)	(5,001)	(5,619)	(4,800)	(5,309)
Operating Profit	37,745	48,716	41,899	11,943	31,132
Net Interest & Other Income	9,934	12,935	3,855	6,788	8,139
Associates	NA	NA	NA	NA	NA
Pretax Income	47,679	61,652	45,754	18,731	39,271
Tax (expense) / Benefit	(8,482)	(10,388)	(8,485)	(3,746)	(7,854)
Net Income (Adjusted)	39,196	51,264	37,269	14,985	31,417
Average Fully Diluted Shares Outstanding	11,556	11,689	12,115	12,596	12,596

Key Cash Flow Statement Data

Net Income	39,196	51,264	37,269	14,985	31,417
Depreciation & Amortization	9,864	12,077	13,369	14,782	16,554
Change in Working Capital	4,531	(4,063)	(13,621)	3,866	(891)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(5,940)	(6,561)	3,186	(4,275)	(4,727)
Cash Flow from Operations	47,651	52,717	40,203	29,358	42,353
Capital Expenditure	(12,912)	(16,754)	(20,000)	(22,000)	(26,000)
(Acquisition) / Disposal of Investments	(1,378)	10,386	(1,000)	(1,000)	(1,000)
Other Cash Inflow / (Outflow)	(1,515)	(821)	0	0	0
Cash Flow from Investing	(15,804)	(7,189)	(21,000)	(23,000)	(27,000)
Shares Issue / (Repurchase)	0	0	5,760	0	0
Cost of Dividends Paid	(39,642)	(30,835)	(40,242)	(27,899)	(29,371)
Cash Flow from Financing	(33,389)	(37,286)	(34,482)	(12,899)	(19,371)
Free Cash Flow	34,739	35,962	20,203	7,358	16,353
Net Debt	6,327	4,271	19,550	41,090	55,105
Change in Net Debt	5,110	(13,677)	15,279	21,541	14,018

Key Balance Sheet Data

Property, Plant & Equipment	110,453	115,770	122,401	129,619	139,065
Other Non-Current Assets	80,127	86,661	88,536	91,476	96,596
Trade Receivables	4,346	4,379	5,481	4,546	5,006
Cash & Equivalents	33,448	30,045	14,766	8,226	4,211
Other Current Assets	37,252	45,086	60,333	57,687	59,024
Total Assets	265,627	281,941	291,517	291,553	303,901
Long-Term Debt	23,165	24,161	24,161	34,161	49,161
Other Non-Current Liabilities	1,730	1,982	6	7	8
Short-Term Debt	16,610	10,155	10,155	15,155	10,155
Other Current Liabilities	20,589	22,987	31,753	29,701	30,002
Total Liabilities	62,094	59,285	66,075	79,024	89,326
Total Equity	203,533	222,655	225,442	212,529	214,575
Total Equity & Liabilities	265,627	281,941	291,517	291,553	303,901

iQmethodSM - Bus Performance*

Return On Capital Employed	13.5%	16.3%	13.3%	3.8%	9.5%
Return On Equity	19.6%	24.1%	16.6%	6.8%	14.7%
Operating Margin	21.2%	23.4%	16.1%	5.5%	13.1%
EBITDA Margin	26.8%	29.2%	21.2%	12.4%	20.1%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.2x	1.0x	1.1x	2.0x	1.3x
Asset Replacement Ratio	1.3x	1.4x	1.5x	1.5x	1.6x
Tax Rate (Reported)	17.8%	16.8%	18.5%	20.0%	20.0%
Net Debt-to-Equity Ratio	3.1%	1.9%	8.7%	19.3%	25.7%
Interest Cover	NM	NM	NM	18.7x	45.8x

Key Metrics

* For full definitions of iQmethodSM measures, see page 6.

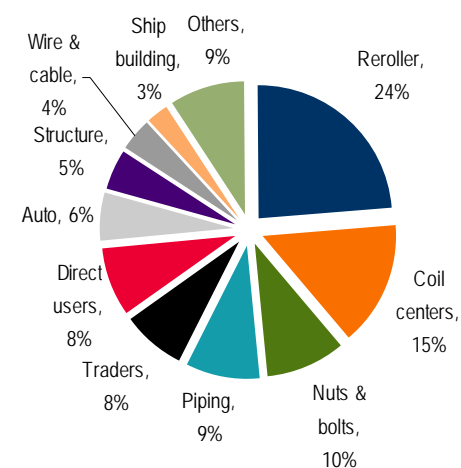
Company Description

Founded in 1971 and listed on the Taiwan Stock Exchange in 1974, China Steel Corp. (CSC) is Taiwan's only integrated steel maker with domestic leading position in upstream steel products- hot rolled coils (HRC), cold rolled coils (CRC), steel plates and so on. Its crude steel production volume was 11m tons in 2006, 43% of domestic market share. Its sales volume could be broken down into HRC (43%), CRC (27%), bars and wire rods (17%), plates (11%)

Investment Thesis

A lack of new technology initiatives in the foreseeable future and a failure to fully pass-through raw material price hikes to customers are the major headwinds to China Steel's earnings growth, in our view. We expect earnings to decline in 2009. Any upside would have to come from its gross margin expansion, which is not expected in the near future as the company's major customers are facing weak profitability.

Chart 1: Sales volume in 2007



Source: Company

Stock Data

Shares / GDR	20.00
Price to Book Value	1.2x

Table 1: Earnings cut of 13%/11% in 2009E-10E

NT\$m	Original version			New Version			% change		
	2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2010E
Sales	260680	226949	249743	260236	215837	237706	0%	-5%	-5%
Gross profits	49064	21300	43025	49077	18323	38189	0%	-14%	-11%
Operating profits	41886	14800	35841	41899	11943	31132	0%	-19%	-13%
Pre-tax profits	45741	21588	43980	45754	18731	39271	0%	-13%	-11%
Net Profits	37258	17271	35184	37269	14985	31417	0%	-13%	-11%
EPS	3.08	1.37	2.79	3.08	1.19	2.49	0%	-13%	-11%
Gross margin	18.8%	9.4%	17.2%	18.9%	8.5%	16.1%			
Operating margin	16.1%	6.5%	14.4%	16.1%	5.5%	13.1%			
Net margin	14.3%	7.6%	14.1%	14.3%	6.9%	13.2%			

Source: Source: Merrill Lynch

Table 2: Quarterly earnings forecast

NT\$m	1Q08A	2Q08	3Q08	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E
Sales	57,353	66,970	76,886	59,027	50,019	50,693	56,816	58,309
Gross profits	12,740	17,904	18,839	(406)	(2,798)	(996)	10,243	11,874
Operating profits	10,999	16,015	16,891	(2,006)	(4,378)	(2,576)	8,633	10,264
Pre-tax profits	14,336	18,836	15,348	(2,766)	(3,388)	(1,186)	10,423	12,882
Net Profits	11,713	15,187	12,582	(2,213)	(2,710)	(948)	8,339	10,305
EPS	0.97	1.25	1.04	-0.18	-0.22	-0.08	0.66	0.82

Source: Merrill Lynch and company

Table 3: China Steel is global most expensive steelmaker

	P/E (x)		P/B (X)		ROE (%)		Dividend yield	
	2008E	2009E	2008E	2009E	2008E	2009E	2008E	2009E
China Steel	7.0	18.1	1.2	1.3	16.6	6.8	10.3%	4.0%
Global average	4.3	4.8	0.7	0.7	23.1	16.4	9.5%	7.3%
Asia Pacific peer (ex. Japan)	5.2	7.4	0.9	0.8	18.3	14.4	8.2%	6.7%
Japan average	5.4	5.4	1.0	0.9	17.8	17.2	4.7%	4.9%
China average	5.4	6.4	0.9	0.8	15.2	12.6	6.8%	6.1%

Source: Merrill Lynch

Table 4: Financial forecasts

NT\$m, year-end Dec	2007	2008E	2009E	2010E
Income Statement				
Net sales	207919	260236	215837	237706
Sales growth	17.0%	25.2%	-17.1%	10.1%
Gross profit	55053	49077	18323	38189
Gross margin	26.5%	18.9%	8.5%	16.1%
Operating income	48716	41899	11943	31132
Operating margin	23.4%	16.1%	5.5%	13.1%
Pre-tax income	61652	45754	18731	39271
Pre-tax margin	29.7%	17.6%	8.7%	16.5%
Income tax rate	16.8%	18.5%	20.0%	20.0%
Net income	51264	37269	14985	31417
EPS	4.39	3.08	1.19	2.49
Earnings growth	29.3%	-29.9%	-61.3%	109.7%
Net margin	24.7%	14.3%	6.9%	13.2%
Fully diluted EPS	4.38	3.08	1.19	2.49
EBIT	62,222	46,258	19,371	39,951
EBIT margin	29.9%	17.8%	9.0%	16.8%
EBITDA	74,298	59,627	34,154	56,505
EBITDA margin	35.7%	22.9%	15.8%	23.8%
Balance sheet				
Cash & mkt. securities	30,045	14,766	8,226	4,211
Total current assets	79510	80580	70458	68241
Non-current assets	202431	210937	221094	235661
Total assets	281941	291517	291553	303901
Total current liab.	33,142	41,908	44,856	40,157
Non-current liab.	26,143	24,167	34,168	49,169
Total liabilities	59285	66075	79024	89326
Common stocks	114,963	125,958	125,958	125,958
Total Equity	222,655	225,442	212,529	214,575
IB debt	34,316	34,316	49,316	59,316
Net debt	4,271	19,550	41,090	55,105
Cash flow				
Net income	51264	37269	14985	31417
Depreciation & amortization	12077	13369	14782	16554
Cash earnings	63340	50638	29767	47971
Change in working capital	-4063	-13621	3866	-891
Other op. CF changes	-6561	3186	-4275	-4727
Operating cash flow	52717	40203	29358	42353
Net capital expenditures	-16,754	-20,000	-22,000	-26,000
Change in LT investment	-682	-1,000	-1,000	-1,000
Other inv. CF changes	10247	0	0	0
Investing cash flow	-7189	-21000	-23000	-27000
Free cash flow	45527	19203	6358	15353
Dividend paid	-30,835	-40,242	-27,899	-29,371
Equity financing	0	5,760	0	0
Debt financing	-5,436	0	15,000	10,000
Other fin. CF changes	-1,015	0	0	0
Financial cash flow	-37286	-34482	-12899	-19371
Exchange influence	0	0	1	2
Change in cash flow	8242	-15279	-6540	-4016

Source: Merrill Lynch and company

Price objective basis & risk

China Steel Corp (CISEF / CISXF)

Our PO for China Steel Corp. is NT\$17/share (GDR - USD10.3). We derive our fair value by using DCF. Assumptions used in our DCF are a 9.4pct WACC and 3pct long-term growth rate. Our PO translates to 1.0x 2009E P/BV. Risks: If the company is able to more than fully pass on cost hikes to customers, there may be potential upside. Shares could rise if it delivers earnings that are better than consensus forecasts. The share price could decline in excess of our PO if the company is unable to pass on most of the cost hikes to customers.

Analyst Certification

I, Albert Hsu, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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APR - Metals & Mining Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Banpu Pcl	BPULF	BANPU TB	Komsun Suksumrun
	China Shenhua-H	CUAEF	1088 HK	Alexander Latzer
	Intl Nickel In	PTNDF	INCO IJ	Daisy Suryo
	PT Adaro Energy Tbk	XPDRF	ADRO IJ	Daisy Suryo
	PT Bayan Resources Tbk	XBAYF	BYAN IJ	Daisy Suryo
	Tambang Batubara	PBATF	PTBA IJ	Daisy Suryo
	Yanzhou Coal	YZCHF	1171 HK	Alexander Latzer
	Yanzhou Coal -A	YZC	YZC US	Alexander Latzer
	Zijin Mining - H	ZIJMF	2899 HK	Alexander Latzer
NEUTRAL				
	Chalco	ACH	ACH US	Alexander Latzer
	Chalco	ALMMF	2600 HK	Alexander Latzer

APR - Metals & Mining Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
	Hindalco	HNDFF	HNDL IN	Vandana Luthra
	Jiangxi Copper-A	JIXAY	JIXAY US	Alexander Latzer
	Jiangxi Copper-H	JIAXF	358 HK	Alexander Latzer
	Sterlite Industr	XTNDF	STLT IN	Vandana Luthra
	Sterlite Industries India Limited	SLT	SLT US	Vandana Luthra
UNDERPERFORM				
	Aneka Tambang	XANEF	ANTM IJ	Daisy Suryo
	Angang	ANGGF	347 HK	Alexander Latzer
	Baosteel	BAOSF	600019 CH	Alexander Latzer
	China Steel	CISXF	CISXF US	Albert Hsu
	China Steel Corp	CISEF	2002 TT	Albert Hsu
	Gloria Material	GLMTF	5009 TT	Albert Hsu
	Jindal Steel and Power Limited	XJDLF	JSP IN	Bhaskar.N.Basu,CFA
	JSW Steel	XJWJF	JSTL IN	Bhaskar.N.Basu,CFA
	Maanshan I & S-H	MISCF	323 HK	Alexander Latzer
	NALCO	NAUDF	NACL IN	Vandana Luthra
	Steel Authority	SLAUF	SAIL IN	Vandana Luthra
	Tata Steel	TAEUF	TATA IN	Vandana Luthra
	Wuhan Steel	WHNIF	600005 CH	Alexander Latzer
REVIEW				
	China Oriental	CUGCF	581 HK	Alexander Latzer
	POSCO	PKXFF	005490 KS	Alexander Latzer
	POSCO -A	PKX	PKX US	Alexander Latzer

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
	Amortization	Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales}$	
	Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

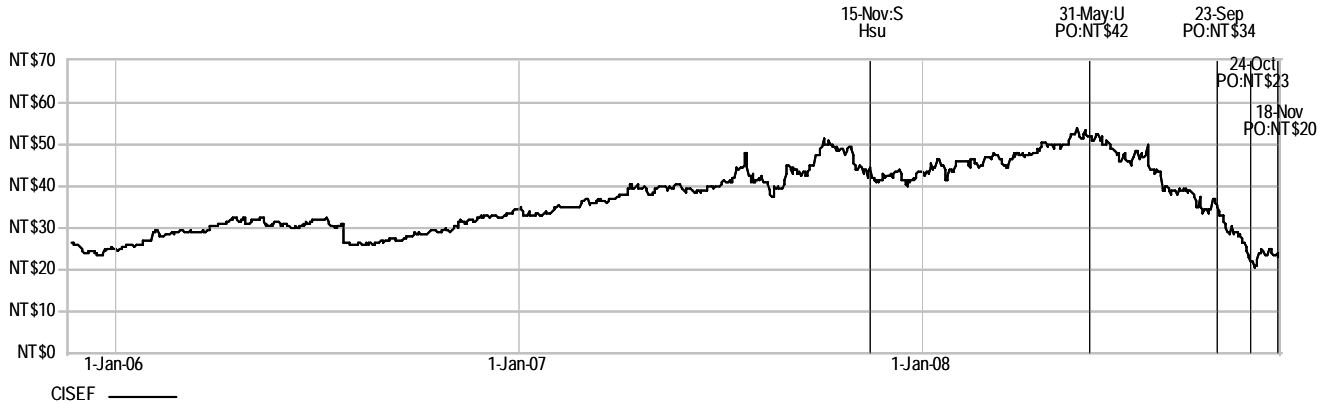
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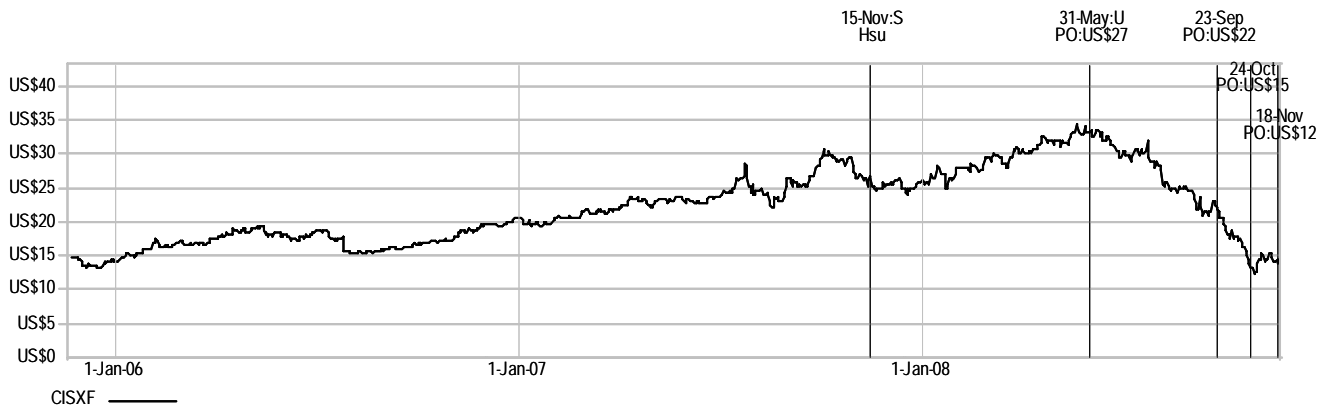
CISEF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of October 31, 2008 or such later date as indicated.

CISXF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of October 31, 2008 or such later date as indicated.

Investment Rating Distribution: Steel Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	37	71.15%	Buy	6	20.00%
Neutral	5	9.62%	Neutral	0	0.00%
Sell	10	19.23%	Sell	2	22.22%

Investment Rating Distribution: Global Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1647	45.31%	Buy	429	28.83%
Neutral	858	23.60%	Neutral	240	31.41%
Sell	1130	31.09%	Sell	227	22.02%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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