DJ Carmichael

RESEARCH

INDUSTRIALS

24th February 2010

RECOMMENDATION: Buy

PRICE TARGET:

$0.21 per share

6 month vol	14m
12 month share low	$0.04
12 month share high	$0.20

Market Risk	High
Liquidity Risk	Very High
Infrastructure Risk	Medium
Country Risk	Medium

IRESS & DJC Research

ISSUED CAPITAL

ASX,	CNH
Share price	$0.135
Mkt cap.[1]	$64.9m
Ordinary shares on issue	480.8m
Options	22.7m

1 Post debt to equity swap. Undiluted

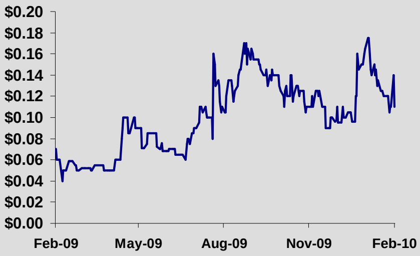
Source: DJC, IRESS

DIRECTORS

Chen, Lidong	Managing Director
Xue, Yongwen	Chairman
Damien Seah	Alternate Chairman
Lanson Lim	Alternate Director
Peter Carroll	Non-Exec Director
Sherman Tan	Non-Exec Director
Paul Frederiks	Non-Exec Director

Source: TOX

12 MONTH PERFORMANCE



Source: IRESS

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China Steel Australia Limited (CNH)

Initiating coverage – Leveraged to Chinese growth story

Despite its name, CNH is not involved in the production of steel. CNH listed in February 2008 as a producer of nickel pig iron (NPI), which is used by Chinese stainless steel producers as an alternative to pure nickel in the production of stainless steel. CNH is not exposed to the price variability of raw materials as it operates as a simple through put operation with stainless steel customers supplying many of the raw materials required and acquiring all of the NPI produced. CNH is one of only a few NPI plants in China and its blast furnace plant in Shandong is operating at full capacity. It is in the process of completing the construction of its second plant, which will see NPI capacity quadrupled from 45,000 to 195,000 tonnes p.a. We believe the stock has been overlooked since it has listed, but is now poised to become a major leveraged play on Chinese growth. In our view, CNH is a unique company on the ASX, and one that provides investors with direct exposure to the largest stainless steel market in the world and the Chinese growth story. We commence coverage with a Buy recommendation and price target of $0.21.

Management: We believe the board is more than capable and importantly has highly regarded Chinese directors that have the local know-how and the right political connections. We note the Chairman is a congressman for Shandong and also the MD for China Powerplus. Post the debt for equity conversion, China Powerplus will hold a 30% stake in CNH and is a Singapore listed company that designs, produces and sells portable power tools in the agricultural and gardening industries throughout the world. Jadefield group is CNH's largest major shareholder with a 47% stake, and is the investment company of Lanson Lim who is a company director.

Valuation: In our view, CNH offers compelling value at current prices and we believe it has been trading below inherent value. CNH trades below our FY11 NTA forecast of $0.16 and at a 57% discount to our DCF/PER price target of $0.21. We expect that the share price will be re-rated once the funding for BF2 is finalised and management sign letters of intent confirming forward demand. While execution risk exists, the risk in our forecasts is to the upside. Once BF2 is completed and operating at full capacity, CNH will generate significant cash flow for management to consider paying a dividend subject to future growth opportunities.

Investment Summary

Y/E June	**2008A**	**2009A**	**2010E**	**2011E**	**2012E**
Earnings					
Net Profit ($m)	13.1	-3.1	0.3	10.7	16.7
Adjusted Net Profit ($m)	8.5	-1.2	2.1	10.7	16.7
Fully Diluted Adj EPS (cents)	2.9	-0.4	0.5	1.5	2.4
PER (x)	4.7	na	25.3	8.9	5.7
NTA/Share (cents)	7.9	7.8	14.9	16.1	18.0
Cashflow per share (cents)	-5.5	2.8	0.7	4.8	5.1
P/CFPS (x)	-2.4	4.8	19.4	2.8	2.6
Adjusted EBITDA ($m)	10.3	1.4	4.4	19.1	28.0
Enterprise Value ($m)	81.3	96.7	93.9	89.1	64.3
EV/EBIT	9.1	-429.9	29.8	6.8	3.0
EV/EBITDA	7.9	66.8	21.3	4.7	2.3
Net Debt/Equity	180%	231%	net cash	net cash	net cash

Company overview

CNH is a supplier of feed materials for the steel and stainless industry in China. Through its plant near the city of Linyi in Shandong province of China, the company processes merchant pig iron (MPI) which is used by electric arc furnace (EAF) steelmakers as a clean scrap alternative, and nickel pig iron (NPI) which is used as an important alternative to nickel in the production of stainless steel. NPI is its biggest focus and provides the highest margins.

CNH's growth is linked to the growth of the Chinese economy. Demand for CNH's NPI is very strong currently due to the current robust demand for stainless steel in China and the competition for pure refined nickel. CNH's Linyi plant is currently running at full capacity of 45,000 tonnes p.a and operates principally as a simple through put operation with customers supplying many of the raw materials (eg. Coke and nickel ore) required and acquiring all of the NPI produced.

Key Attractions

In our view, the key attractions of CNH are:

Full capacity market leader – CNH is the largest producer of NPI in Shandong and one of approximately 10 producers left in China and a market leader when it comes to blast furnace processing. CNH are one of the only blast furnace producers who are able to achieve very high efficiency when producing NPI containing between 6-12% nickel. CNH's current cost of production is around US$5.6/lb which is in line if not below electric arc furnace mills.

4 fold jump in capacity underway – CNH is in the process of ramping up processing capacity of NPI from 45,000 to 195,000 tonnes pa by completing the construction of its second blast furnace. Post this expansion, we forecast that its free cash flow profile will improve dramatically (circa $20 FCF p.a).

Leverage to China growth – CNH offers direct exposure to the Chinese growth story via robust domestic stainless steel demand. The recovery of the LME nickel price since December has brought Chinese production of NPI back to life, and CNH blast furnace is now operating at full capacity from increased demand from stainless steel producers.

Fully approved foreign owned Chinese mill: CNH holds a Wholly Foreign Owned Enterprise (WOFE) steel and alloy mill business licence valid till 2019. The Chinese Government has restricted the issue of these licenses particularly to new or foreign owned enterprises. In addition, many NPI producers in China have been shut down by the Chinese government since 2007 which has caused substantial demand pressure on remaining producers like CNH.

Access to coke plant and transportation facilities - Coke is one of the main raw materials used by CNH in the production of NPI. CNH's Linyi plants are located near several large scale coke plants, giving the company an added advantage in terms of supply and lead time. Major transportation facilities are also in close proximity enabling a reduction in the cost of production.

Limited exposure to input prices - CNH's plant operates principally as a simple through put operation with customers supplying many of the raw materials (coking coal and nickel ore) required and acquiring all of the NPI produced. Therefore CNH is not exposed to price variability of the raw materials.

Restructured balance sheet - We anticipate that the debt to equity conversion will be approved, which will significantly recapitalise the balance sheet and put CNH in a net cash position.

History

CNH listed in February 2008 at 20 cents with a market capitalisation of $61.6m. It raised $3m, which represented only 5% of the shareholder base due to a weak market at that point in time and its capex program was largely funded by its major shareholders/directors. At listing, its Linyi Plant was at full capacity producing nickel pig iron. Demand for NPI was strong due to the considerable growth in China and its demand for stainless steel. CNH exceeded FY08 prospectus forecast earnings recording NPAT of $13.1m and revenue of $22.5m. However, over FY09, CNH experienced a significant fall in demand after nickel prices tumbled towards US$4/lb and stainless steel producers used raw nickel instead.

Since then, nickel prices have rebounded over US$8/lb and respective demand for NPI increased with its plant operating at full capacity. Conditions have improved considerably and prospects going forward are exciting.

What is Nickel Pig Iron (NPI)?

NPI is an alloy that contains 3-15% nickel with the remainder primarily being iron. It is produced from low quality laterite nickel ores that contains between 1-2% cent nickel. Laterite nickel ores accounts for two-thirds of the world nickel resources.

NPI has only become common in China over the last few years. The shortage of nickel supply and surge of nickel prices in 2006 severely affected China's stainless steel industry, giving rise to demand from Chinese stainless steel producers for an alternative to nickel. CNH was one of the first to step in and fulfill this demand by producing the alternative - NPI in 2006.

By adding chromium and other materials to NPI, 200 and 300 series stainless steel is produced; these types of steel constitute more than 70% of China's total stainless steel production. A basic overview of the production process is set out in Appendix 1.

CNH is one of the largest nickel pig iron producers in China, producing approximately 45,000 tonnes of NPI p.a. from its blast furnace plant. CNH has proven itself as a leading low cost producer of high quality NPI.

Initially nickel pig iron was solely viewed as a cheaper substitute compared to nickel but over the last two years, the quality of nickel pig iron has grown to become a reliable alternative to nickel. Coupled with the fact that NPI is produced domestically in China, Chinese stainless steel producers now view NPI as an important domestic source of supply as opposed to relying solely on the import of nickel from overseas to fulfill China's domestic shortfall.

There are some NPI electric furnaces being built now, in addition to a couple of NPI blast furnace too. Electric furnaces produce much lesser quantity but higher quality (13%+ grade). However, we note that around 80% of stainless steel produced in China is still of lower grade (6-12%) – which is CNH's target market.

What is Merchant Pig Iron (MPI)?

MPI is used by electric arc furnace (EAF) steelmakers as a clean scrap alternative. EAF steel-making plants represent about 35% of world steel production and will use around 30% of scrap alternates, such as MPI which is very low in impurities, to reduce the percentage of the contaminants in each batch of steel.

The Chinese government has been promoting the use of EAF for environmental reasons. EAF accounted for about 15% of steel production in China in 2007 and has registered double digit growth yearly. (59% of USA's steel production is EAF). Another use of MPI is for casting articles in foundries such as automotive parts, stoves, pipes, radiators, lamp-posts and rails. China is the world's largest metal casting producer and accounts for more than 30% of world production.

While MPI commands lower margins than NPI (7% gross margin versus 14% gross margin respectively), MPI demand is relatively more stable and would provide CNH with the flexibility to produce another product should demand for NPI fall.

Domestic Chinese Stainless Steel Industry

Stainless steel uses: Stainless steel is a metal alloy of nickel, iron, chromium and other metals. Stainless Steel is used widely in items such as automotive and food processing products, as well as medical and health equipment. Its uses include the following:

Application in	Products
Domestic	Cutlery, Kitchen sinks, cookware
Construction	Bus shelters, street lamps, street barricades, lifts, escalators, trains, building pipes, building structures
Industrial	Food manufacturing equipment, pharmaceuticals, water treatment plants, chemical plants, components for automotive and aeronautic engines, fuel tankers

Fig 1: Uses of stainless steel *Source: CNH*

There are different types, grades and surface finishes of stainless steel to suit the use of the product. CNH's NPI is used in the manufacture of 200 series and 300 series stainless steel, which comprises the large majority of the stainless steel produced worldwide.

Demand for stainless steel in China: China remains the world's largest stainless steel producer, accounting for ~37% of world production in 2009.

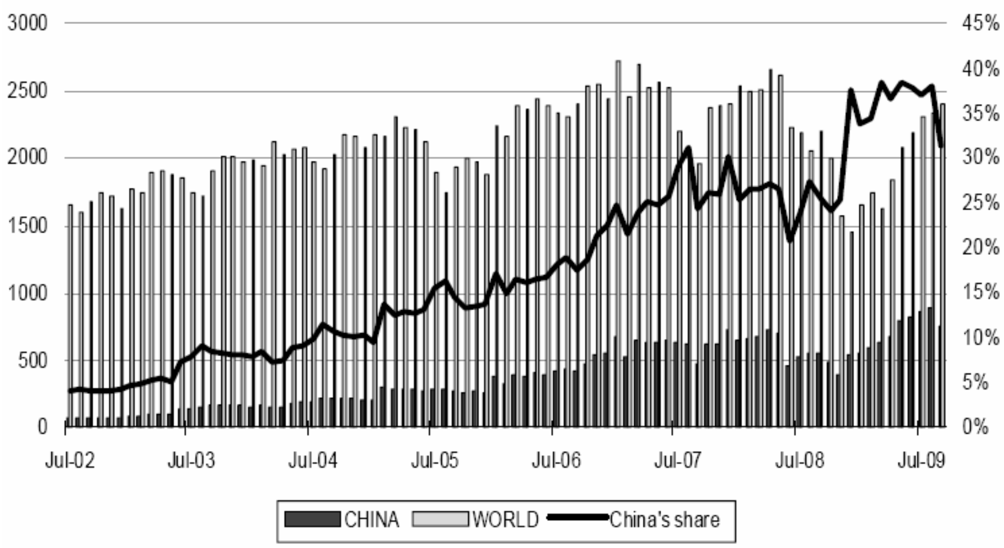

Fig 2: China and ex-China SS production (kt) and China's market share *Source: CRU, Credit Suisse*

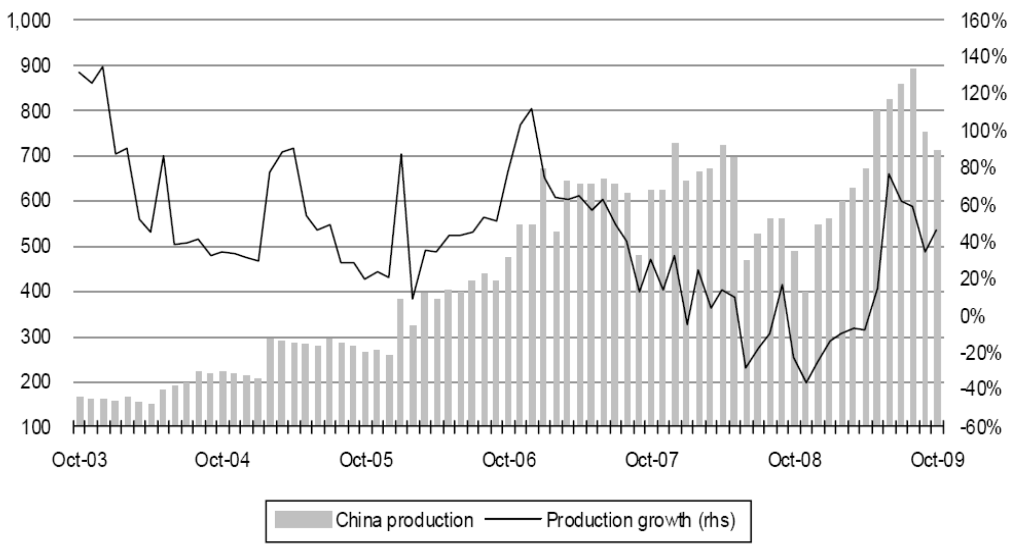

Fig 3: China Stainless steel production (kt) and y/y growth *Source: CRU, Credit Suisse*

Following on from the impact of the GFC, the Chinese steel industry has consolidated considerably following government imposed restrictions aimed at the excess capacity. The Chinese government has stopped issuing new licenses or approvals for new capacity. The government has also limited the access to funding of many mills from banks. It is estimated that over 700 mills out of the 800+ steel and iron mills have been shut down.

China's recovery from the GFC and its repercussions has been far more rapid and sustained. Indeed, China's GDP, grew at 10.7% annualised in the December 09 quarter. Huge fiscal stimulus and expansionary lending practices has spurred on economic activity.

Construction and household appliances currently represent around 45% of global demand for stainless steel. With the lagged effect of residential construction (1 year) on demand for stainless steel, China's residential construction market should positively affect stainless steel demand over 2010 as 2H09 housing construction translates into finished apartments. However, there is potential risk of a deceleration of growth further out if the Chinese government further tightens its measures against inflation risk.

Recent reports of stainless steel demand picking up particularly from China has been encouraging. While inventory restocking and private speculation have clearly occurred, we note that Chinese stainless steel mills are ramping up production and the majors, such as TISCO, POSCO and Baosteel, have expanded production significantly and also increased export stainless steel prices.

The impact of the Nickel price: Stainless steel production accounts for around two-thirds of total nickel consumption. The collapse in demand for Chinese stainless steel resulted in a sharp drop in NPI production in the second half of 2008 and early 2009. However, the rebound in stainless steel production and nickel prices in Q2/09 and Q3/09 has resulted in a dramatic revival of NPI production.

Stainless steel producers in China use both NPI and pure nickel in their production. Therefore the cost of sourcing NPI and the price of nickel will determine which one stainless steel mills demand more of.

Over the past two years, the nickel market has pulled back significantly following the spectacular ride of 2006-2007 where very strong stainless steel production growth combined with a limited supply-side response pushed nickel prices to an amazing peak of US$24/lb in May 2007. Nickel prices eventually came back down to earth due to substantial stainless steel destocking which was exacerbated by the GFC, with nickel prices bottoming at US$4.05/lb in December 2008. Nickel prices of US$4-5/lb severely impacted the Chinese NPI industry.

The recent recovery of nickel prices towards US$10/lb, has revamped Chinese production of NPI again. We understand that almost all NPI producers in China are now profitable again since December 2009. It is estimated that cash cost margins for independent electric arc furnaces and blast furnace operators are around US$7/lb and US$8/lb, respectively, at the moment compared with the US$9.3/lb of cash nickel price quoted on the LME at the time of writing.

This year's average nickel price according to consensus is expected to be around US$8.35/lb, up from US$6.6/lb in 2009. Similar to 2009, the nickel market appears close to balanced in the near-term with high LME stockpiles counteracting strong anticipated stainless steel recovery.

Nickel demand is expected to rebound in 2010 with an expected pick up in the global economy. The International Nickel Study Group has forecast that world nickel production will jump to 1.44m metric tonnes in 2010 from 1.28m in 2009, a 12.5% jump based on projected stronger purchasing by Asian stainless steel producers, especially those in China.

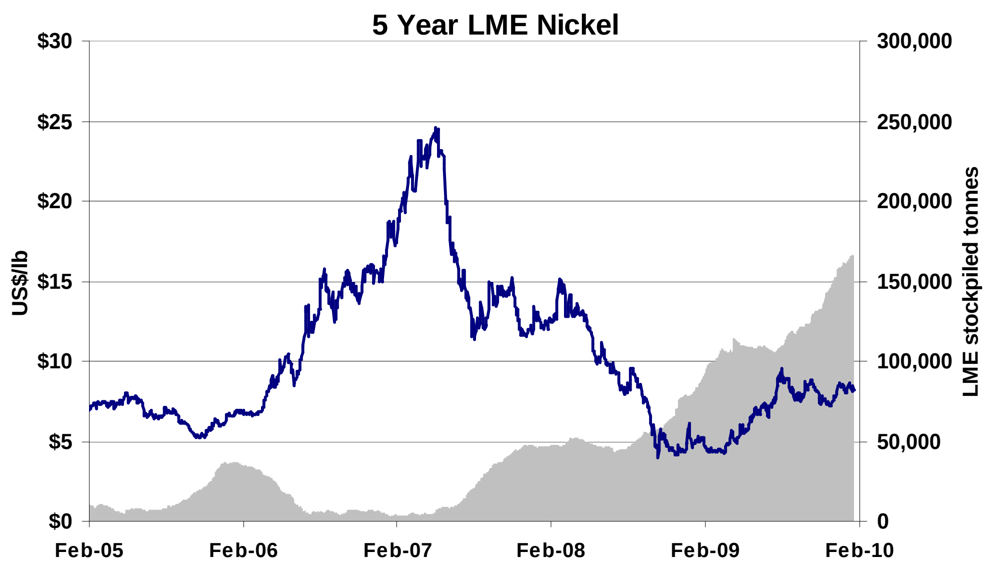

Fig 4: Nickel Prices and Stockpiles *Source: Iress, DJC*

Licensing

CNH has met the environment standards set by the Chinese government and has been issued a letter of certification from the Linyi Bureau of Environmental Protection in 2007.

CNH also holds a Wholly Foreign Owned Enterprise (WOFE) a steel and alloy mill business licence valid till 2019. The Chinese Government has restricted the issue of these licenses particularly to new or foreign owned enterprises.

Key Customers

In January, CNH announced it had signed a one year letter of intent with Heng Feng Zheng Dao Trading Co (Heng Feng) to supply 45,000 tonnes of NPI underpinning future production and effectively puts demand at 90,000 tonnes.

CNH's current customer mix and their breakdown of BF1 capacity is as follows:

Customer	% of BF1 production	Profile
Heng Feng	65	Raw material trading house that supplies to the stainless mills
Shandong Changling Machinery Group Co	20	Specialty stainless producer focusing on machinery parts
Linyi County Xing Hua Machinery Co	15	Specialty stainless producer

Fig 5: Current customer base *Source: CNH*

The Linyi Plant

CNH produces both NPI and MPI at its plant near the city of Linyi in China's Shandong Province.

Shandong is one of the richer provinces of China, and is the biggest industrial producer and one of the top manufacturing provinces. Shandong's population is ~100 million. In 2009, the nominal GDP for Shandong was 3.4 trillion yuan (AUD$565 billion), ranking third in China (behind Guangdong and Jiangsu). It's GDP per capita was 35,893 yuan (AUD$6,000), ranking eighth. Shanghai is approximately 550km away.

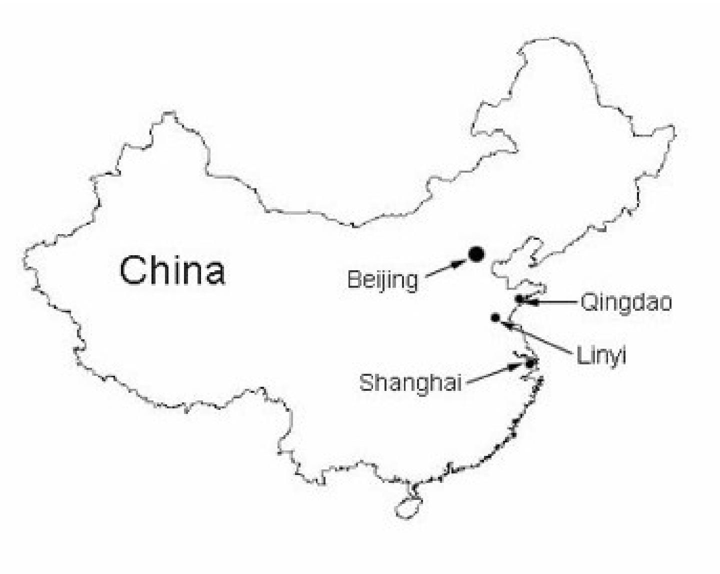

Fig 6: Linyi, Shandong *Source:global-gal.com*

The Linyi Plant is located near the city of Linyi, in Shandong Province on the eastern coast of China. There are over 450 employees, including 50 engineers and technicians. Key management have over 60 years combined experience in the steel and alloy processing industries.

The Linyi Plant is close to coke supplies as well as road, rail and sea infrastructure. It is less than 100km from Rizhao Port, one of the major ports of China.

The Linyi Plant currently operates as a throughput plant, relying on its customers to supply nickel ore and other raw materials to produce NPI and MPI.

Operations and emission from the plant are subject to compliance with local Chinese environmental regulations. Linyi Yilida Steel (100% owned subsidiary) holds the required environmental certification issued by the Linyi Bureau of Environmental Protection.

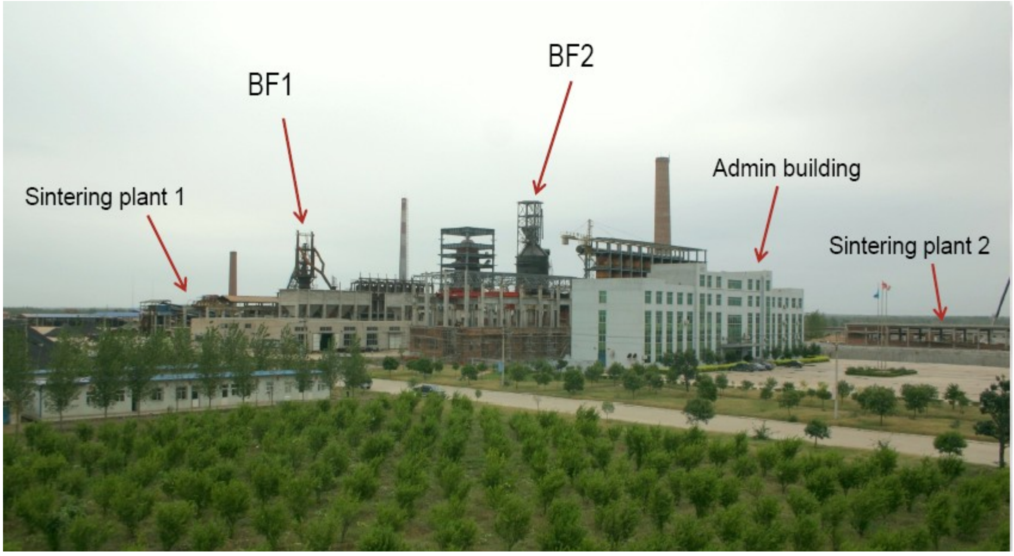

Fig 7: Linyi Plants *Source: CNH*

Blast Furnace 1 – operating at full capacity of 45,000 NPI tonnes p.a

Fig 8: Blast furnace 1 *Source: CNH*

BF1 was completed in 2005 at a cost of $30m. It is situated over 350,000 square metres and has a total capacity of 45,000 tonnes of NPI per year or 200,000 tons of MPI per year.

During 2008, CNH converted its plant to also produce MPI. This conversion has given the company the ability to capitalise on changing market demands. CNH commenced production of MPI production in October 2008.

However, a rebound in nickel prices over 2009 and increased demand from the Chinese domestic construction and consumer appliance industries has seen BF1 switch back to processing the higher margin NPI.

BF1 is now running at full capacity following recent contract wins. Demand for NPI is expected to remain strong, and CNH hopes to capitalise on this by completing the construction of its second blast furnace plant as soon as possible.

Blast Furnace 2 – 55% complete. Full capacity of 150,000 NPI tonnes p.a

BF2 is currently 55% complete with ~$48m already spent towards construction. The total cost is expected to be $100m and will have a total capacity of 150,000 tonnes per year or 600,000 tons of MPI per year.

Fig 9: Blast furnance 2 *Source: CNH*

The completion of BF2 is a high priority for management, given that BF1 is running at full capacity. Upon completion, CNH will be the one of the largest producers of NPI in China with a combined production capacity of BF1 and BF2 of at least 195,000 tonnes of NPI per year or 4 times current capacity.

Following the restructure of the balance sheet (conversion of $52m in debt to equity) which puts the company into a net cash position, we envisage that the company will look at raising ~RMB300m (AUD$48.4m) to complete BF2 through a mixture of debt and equity. We anticipate that it would take around 6 months to complete BF2 once funding is sourced.

Following completion, we believe that BF2 should reach full capacity within 3 months from completion. Demand is very strong and we expect management to sign further letter of intents from several parties over the next few months.

Balance sheet – conversion of $52m debt to equity at $0.30

As at 30 June 2009, CNH had a total of $54m of debt to four different lenders, putting CNH's net debt/equity at a high 230%. The increase in debt has been used to fund the construction of BF1 and approximately 55% of BF2.

The major lenders have agreed to convert their loans into shares and options in a debt for equity swap, which was approved by shareholders on 23rd February.

Name	Description	Amount owing (RMB)	Amount owing (AUD$)	% of total debt
Shandong Hengtai Jiaohua Co. Limited	Private company, coking coal supplier	152,938,454	24,667,493	47%
Jadefield Group Limited	Major shareholder	155,302,000	25,048,710	48%
Zhang Guangxia	Private Chinese investor	14,698,000	2,370,645	5%
Total		**322,938,454**	**52,086,847**	**100%**

Fig 10: CNH's major lenders *Source: CNH*

The debt to equity conversion will be completed at an issue price of $0.30, which was based on the net PPE value of $80m as at 30 June 2009 or ~$0.26. The $0.30 conversion price is a premium of 200% to the VWAP for the 30 days ending 8 January 2010. The options will have an exercise price of $0.36 and an expiry date of 22 February 2012.

This is a major milestone and a very positive development for CNH. The debt to equity conversion at a substantial premium highlights the lenders strong support and confidence in the company. The restructure of the balance sheet puts CNH on a very solid base to complete its plan to finalise the construction of BF2 and capitalise on the strong NPI demand.

A total of 172.8m shares and 21.6m options will be issued. Shandong Hentai has appointed Zhang Guangxia as its nominee to receive its conversion shares and options. No securities are subject to escrow. The number of shares and options issued to the lenders in lieu of their debt is as follows:

Name	**No. of new shares**	**No. of new options**
Jadefield Group Limited	83,109,640	10,388,705
Zhang Guangxia	89,710,406	11,213,801
Total	**172,820,046**	**21,602,506**

Fig 11: Securities received as part of debt swap *Source: CNH*

The debt to equity conversion substantially recapitalises CNH's balance sheet and puts the company into a net cash position. NTA increases significantly by 113% on an undiluted basis.

The table below sets out CNH's pro forma historical balance sheet post the conversion:

$000	**30-Jun-09**	**Post conversion (undiluted)**	**Post conversion (fully diluted)**
Cash	88	88	7,865
PPE	80,115	80,115	80,115
Total Assets	81,505	81,505	89,282
Debt	55,236	0	0
Issued capital	5,483	57,946	65,723
Total Equity	23,904	79,486	87,263
Net debt/Equity	**230.7%**	**-0.1%**	**-9.0%**
No. of shares on issue (00	308,000	480,820	503,523
NTA per share	**$0.08**	**$0.165**	**$0.173**

Fig 12: Pro forma balance sheet post conversion *Source: CNH, DJC*

Major shareholders

Liquidity is a significant issue for investors to consider. Currently Jadefield Group and China Powerplus each hold 46.25% of CNH, equating to a free float of only 7.5%.

China Powerplus Ltd, a Singapore listed company is associated with Mr Xue, Yongwen, CNH's Non-executive Chairman. It is a company that designs, produces and sells portable power tools in the agricultural and gardening industries throughout the world.

Jadefield Group is an investment company whose equal shareholders are Madam Tan Geok Bee and Lanson Lim. Lanson Lim is a director of CNH.

Post the debt for equity conversion, the 3 largest shareholders will hold 95.2% of the company, leaving only 4.8% free float.

Shareholder	% holding
Jadefield Group	46.9
China Powerplus Limited	29.6
Zhang Guangxia (including shares held as nominee for Shandong Hentai)	18.7
Total	**95.2**

Fig 13: Major shareholdings post debt to equity conversion *Source: CNH*

An equity capital raising as part of the funding for BF2 should help improve liquidity.

Historical performance

The following table summarises previous historical performance:

	FY07	FY08	FY09
$000			
Revenue	30,180	22,480	7,189
Gross profit	9,948	11,679	3,353
EBITDA	8,874	10,260	1,449
EBITDA margin	29.4%	45.6%	20.2%
Adjusted NPAT	7,451	8,453	-1,201
NPAT margin	24.7%	37.6%	-16.8%

Fig 14: Historical performance *Source: CNH*

We note the following:

- 2009 was impacted by the GFC and a substantial drop in nickel prices
- The drop in revenue from FY07 to FY08 reflects a change in sale arrangements with its customers. Coke was also removed in the production cost and is being instead supplied by customers. The exclusion of this raw material reduced revenue but increased margins.
- EBITDA margins in FY07, FY08 and FY09 have been in the range of 20-45%

Earnings forecast

We are looking for a reported FY10 NPAT of $0.3m, but after adjusting for $1.85m attributable to the fair value adjusted interest expense, we expect an adjusted NPAT of $2.1m.

Our forecasts post FY10 are based on the premise that CNH will be able to raise RMB300m (approx AUD$48m) to complete the construction of BF2 within 6 months, after which it will be able to ramp up to full capacity within 3 months. We anticipate that both plants will be running close to full capacity from FY12 and that margins remain constant.

The following provides a summary of our forecast expectations:

	FY10	FY11	FY12	FY13
Volume assumptions (tonnes)				
BF1 - Volume				
Max capacity (NPI)	45,000	45,000	45,000	45,000
Utilisation (NPI)	100%	100%	100%	100%
NPI	27,500	45,000	45,000	45,000
MPI	22,500	0	0	0
BF2 - Volume				
Max capacity (NPI)	0	150,000	150,000	150,000
Utilisation (NPI)	0%	58%	90%	90%
NPI	0	86,250	135,000	135,000
MPI	0	0	0	0
Total volume				
NPI	27,500	131,250	180,000	180,000
MPI	22,500	0	0	0
Inflation		3%	3%	3%
Pricing assumption (RMB)				
Avg price per ton NPI	6,800	6,800	7,004	7,214
Avg price per ton MPI	2,457	2,457	2,531	2,607
Revenue				
NPI revenue	187,000,000	892,500,000	1,260,720,000	1,298,541,600
MPI revenue	55,282,500	0	0	0
Total revenue (RMB)	**242,282,500**	**892,500,000**	**1,260,720,000**	**1,298,541,600**
RMB/AUD	6.20			
Total Revenue (AUD$000)	**39,078**	**143,951,613**	**203,341,935**	**209,442,194**
Cost of Sales	-33,742	-123,184	-173,360	-178,561
Adminstrative Expenses	-930	-1,694	-1,994	-2,053
Operating costs	**-34,672**	**-124,877**	**-175,354**	**-180,614**
EBITDA	**4,406**	**19,074**	**27,988**	**28,828**
Depreciation & Amortisation	-1,251	-6,045	-6,635	-6,797
EBIT	**3,155**	**13,029**	**21,353**	**22,031**
Net borrowing costs	-2,813	-818	-775	-143
PBT	**342**	**12,211**	**20,578**	**21,888**
Tax	-43	-1,526	-3,858	-5,472
Reported NPAT	299	10,685	16,720	16,416
Fair value adjustment interest expense	1,850			
Adjusted NPAT	**2,149**	**10,685**	**16,720**	**16,416**

Fig 15: Earnings forecast *Source: DJC*

Valuation

We use a combined relative PER and DCF methodology to value WDS and set out price target at the average of our DCF valuation and PE multiple.

Given there are no direct peer comparisons for CNH, we use a discount (20%) to the Small Ordinaries index to account for the execution risk of a capital raising and debt financing of BF2, the completion of BF2 and subsequent ramp up to full production of BF2. This discount can trade away if CNH can capitalise on the strong NPI demand as quick as possible, including confirmation that full capacity of BF2 has been signed up.

Price Target	**FY11**
PER XSO (Small Ords Index)	11.6
Discount	20%
CNH FY11 EPS	1.5
Multiple used	9.3
PER valuation	**$0.14**
DCF value per share	**$0.28**
Valuation	**$0.21**
Current price	$0.14
Upside to implied price	57%

Fig 16: Valuation *Source: DJC*

Our DCF valuation of **$0.28** is based on the following assumptions:

- WACC of 12.4% and long term growth rate of 3%
- Exchange rate of 6.20RMB to 1AUD
- Debt to equity conversion successful
- 50:50 mix of debt and equity is used to raise RMB300m to complete construction of BF2.
- Debt is increased by 150m RMB (AUD$24m) in FY10
- Equity is increased by 150 RMB (AUD$24) at end of April FY10 at the VWAP of CNH shares over February - $0.128.
- BF2 is completed within 6 months of funding and is running at full capacity 3 months after completion (ie. starts producing in October 2010)
- BF1 is running at full capacity and BF2 at 90% from FY12 onwards
- Capex – Once initial capex has been spent on constructing BF2, maintenance capex is quite minimal.
- Tax rate – CNH's 100% owned subsidiary, Linyi Yilida Steel, is a WFOE and thus enjoys full and then partial income tax relief over a five year period. The effective tax rate is 12.5% until calendar year 2011. From 2012, the company tax rate is at the full 25%.

Note that our DCF assumptions are relatively conservative and include an average EBITDA margin of 13.8% compared to CNH's historical average of 31.8% and a peak margin of 45.6%.

If we assume status quo of BF1 operating at full capacity, our DCF valuation equates to $0.12, while FY11 P/NTA is $0.16.

In our view, CNH offers compelling value at current prices and we believe it has been trading below inherent value. CNH trades below our FY11 NTA forecast of $0.16 and at a 57% discount to our DCF/PER price target of $0.21. We expect that the share price will be re-rated once the funding for BF2 is finalised and management sign letters of intent confirming forward demand. While execution risk exists, the risk in our forecasts is to the upside. Once BF2 is completed and in full production, CNH will generate significant cash flow for management to consider paying a dividend subject to future growth opportunities.

A degree of share price volatility is likely given the low liquidity (which should improve post a capital raising).

Risks

Liquidity – Only 7.5% is free float and for this reason we believe the company has been trading under the radar. Post the debt for equity conversion, the 3 largest shareholders will hold 95.2% of the company, leaving only 4.8% free float. An equity capital raising (in addition to debt) is likely to be used for the final stages of the construction of BF2, which should help improve liquidity.

Nickel prices – If nickel prices fall below ~US$6/lb, it is likely that stainless steel producers will source nickel directly as an alternative to NPI.

Funding for BF2 – CNH is looking at raising approximately RMB300m (AUD$48m) to complete the construction of BF2 through a mixture of debt and equity. CNH may not obtain access to that funding at all or on acceptable terms and conditions.

Foreign exchange – Revenue will be denominated in RMB. An increase in the AUD/RMB rate will negatively impact translated earnings, while a decrease in AUD/RMB rate will positively impact translated earnings.

Directors

In our opinion the board is more than capable and importantly has highly regarded Chinese directors that have the local know-how and the right political connections. We note the Chairman is a congressman for Shandong.

Xue, Yongwen (Non-executive Chairman)
Mr. Xue is the Executive Chairman and Managing Director of China Powerplus Ltd, a company which is listed on the Singapore Stock Exchange. He oversees the overall management and operations of the China Powerplus Ltd Group ("China PowerPlus"). He obtained a Bachelor degree in Economics Management from Shandong Nu Zi Xue Yuan and subsequently graduated from the Industrial and Commercial Management School – Graduate School of the People's University of China with a Master's degree in Business Administration (MBA). Currently, he is also a National People's Congress delegate for Shandong Province, China.

Damien Seah (Alternate Chairman)
Mr. Damien Seah is a nonexecutive director of China Steel Pte. Ltd. and a non-executive director of China Powerplus. He is currently head of the internal audit division of Fabchem China Limited, a company which is listed on the Singapore Stock Exchange. Mr. Seah is a Certified Public Accountant in Singapore and a Fellow of the Association of Chartered Certified Accountants (United Kingdom).

Chen, Lidong (Executive director, CEO)
Mr. Chen joined Linyi Yilida Steel Mill Co. Ltd in 2004, a wholly owned subsidiary of China Steel Australia, as general manager in 2004. He was promoted to CEO when China Steel Australia Limited was listed on ASX in February 2008. Mr. Chen's extensive management includes being Deputy CEO of another conglomerate in China April 1997 to September 2004.

Lanson Lim (Alternate Director)
Mr. Lim is an executive director of China Steel Pte. Ltd. and a non-executive director of Jadefield Group Limited. He is also a director of a number of private companies.

Peter Carroll (Non-executive Director)
Mr. Carroll is a non-executive director of Bemax Resources Limited and was a partner of Deloitte Touche Tohmatsu for many years during which time he advised national and international companies in relation to tax and accounting issues. He is also a director of a number of private companies.

Paul Frederiks (Non-executive Director and Company Secretary)
Mr. Frederiks was previously company secretary and CFO of ASX listed Ross Mining NL for over 8 years until 2000 and Company Secretary for Billabong International Limited from 2000 until 2004 and assisted Billabong with its successful float on the ASX in August 2000. He is currently a non-executive director of Auzex Resources Limited and also CFO and company secretary of ASX listed Geodynamics Limited.

Sherman Tan (Non-executive Director)
Mr. Tan is currently the Group Finance Manager of China Powerplus Ltd, a company which is listed on the Singapore Stock Exchange. He obtained a Bachelor in Accountancy (with Honours) from Nanyang Technological University of Singapore and is currently a Certified Public Accountant in Singapore.

Appendix 1: Basic overview of production process

The basic process for processing NPI is summarised and depicted below.

1. Laterite ore is first crushed into a powder like size in the crushing plant.
2. The crushed ore is then mixed with coke, limestone and other material in mixing machines and transported by conveyor belts to the sintering plant.
3. The raw material mix is then placed on a steel conveyor belt in the sintering plant where it is heated by gas fired furnace to form larger size pieces (called 'sinter').
4. The sinter is moved to the mixing plant where it is mixed with other materials such as coke and limestone in different combinations using computer controlled weight hoppers.
5. The mixed materials are then transported to the top of the furnace where an operator controls the loading order and timing. Hot gas generated from the hot blast stove is channelled into the blast furnace to heat the mixture.
6. The resultant molten nickel pig iron flowing out of the furnace is cast into moulds and ready for delivery.

Fig 17: NPI production process *Source: CNH*

China Steel Australia Limited **$0.135** **Year End 30 June**

Profit & Loss ($m)	08A	09A	10E	11E	12E
Revenue	22.5	7.2	39.1	144.0	203.3
EBITDA	10.3	1.4	4.4	19.1	28.0
Adjusted EBITDA	10.3	1.4	4.4	19.1	28.0
Depreciation & Amortisation	-1.3	-1.7	-1.3	-6.0	-6.6
EBIT	8.9	-0.2	3.2	13.0	21.4
Interest	4.6	-2.9	-2.8	-0.8	-0.8
EBT	13.5	-3.2	0.3	12.2	20.6
Income Tax Expense	-0.5	0.1	0.0	-1.5	-3.9
Minorities	0.0	0.0	0.0	0.0	0.0
Reported NPAT	**13.1**	**-3.1**	**0.3**	**10.7**	**16.7**
Net Abnormal Gain/Loss	4.6	-1.9	-1.9	0.0	0.0
Adjusted Net Profit	**8.5**	**-1.2**	**2.1**	**10.7**	**16.7**

Cashflow ($m)	08A	09A	10E	11E	12E
EBITDA	10.3	1.4	4.4	19.07	28.0
Net Interest	4.6	-2.9	-2.8	-0.82	-0.8
Tax Paid	-0.5	0.1	0.0	-1.53	-3.9
Working Capital change	-26.6	7.3	-1.6	14.38	8.1
Provisions/Other	0.0	0.0	0.0	0.0	0.0
Operating Cashflow	**-12.1**	**5.9**	**-0.1**	**31.11**	**31.4**
Capital expenditure	-35.3	-23.1	-24.2	-24.2	-3.3
Acquisitions & Investments	0.0	0.0	0.0	0.0	0.0
Other	4.6	-1.9	-1.9	0.0	0.0
Net Investing Cashflow	**-30.7**	**-24.9**	**-26.0**	**-24.2**	**-3.3**
Equity raised	5.5	0.0	80.1	0.0	0.0
Buy backs	0.0	0.0	0.0	0.0	0.0
Dividends paid	0.0	0.0	0.0	-2.1	-3.3
Increase (repay) debt	42.1	13.2	-23.6	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Other	1.2	3.9	0.0	0.0	0.0
Net Financing Cashflow	**48.8**	**17.1**	**56.5**	**-2.1**	**-3.3**
Change in Cash	**6.0**	**-2.0**	**30.3**	**4.8**	**24.8**

Balance Sheet ($m)	08A	09A	10E	11E	12E
Assets					
Cash	0.4	0.1	32.3	37.1	61.8
Receivables	9.8	0.0	0.0	0.0	0.0
Inventories	0.4	0.4	2.1	7.5	10.6
Other	0.1	0.2	5.6	5.6	5.6
Current Assets	**10.7**	**0.7**	**40.0**	**50.2**	**78.0**
Intangibles	0.0	0.0	0.0	0.0	0.0
Fixed assets	58.7	80.1	103.1	121.2	117.9
Deferred tax assets	0.0	0.0	0.0	0.0	0.0
Other	0.6	0.7	0.7	0.7	0.7
Non Current Assets	**59.3**	**80.8**	**103.8**	**121.9**	**118.6**
Total Assets	**70.0**	**81.5**	**143.7**	**172.1**	**196.6**
Payables	4.3	2.0	7.5	27.3	38.5
Borrowings	0.0	0.0	0.0	0.0	0.0
Provisions	0.0	0.0	0.0	0.0	0.0
Tax liabilities	0.0	0.0	0.0	0.0	0.0
Current Liabilities	**4.3**	**2.0**	**7.5**	**27.3**	**38.5**
Borrowings	42.1	55.2	31.6	31.6	31.6
Provisions	0.0	0.0	0.0	0.0	0.0
Tax liabilities	0.5	0.3	0.3	0.3	0.3
Non Current Liabilities	**42.5**	**55.6**	**32.0**	**32.0**	**32.0**
Total Liabilities	**46.8**	**57.6**	**39.4**	**59.3**	**70.4**
Net Assets	**23.2**	**23.9**	**104.3**	**112.8**	**126.2**

Company Background

CNH listed on the ASX in February 2008. It has a licence to manufacture steel and iron in China. The company produces both nickel pig iron and merchant pig iron at its plant near the city of Linyi in China's Shandong Province.
www.cnsteel.com.au

Ratios	08A	09A	10E	11E	12E
Profitability					
Revenue Growth	-25.5%	-68.1%	445.6%	268.4%	41.3%
EBITDA Margin	45.6%	20.2%	11.3%	13.3%	13.8%
EBIT Margin	39.7%	-3.1%	8.1%	9.1%	10.5%
NPAT Margin	37.6%	-16.8%	5.5%	7.4%	8.2%
Effective tax rate	3.4%	3.7%	12.5%	12.5%	18.8%
Payout ratio	0.0%	0.0%	0.0%	20.0%	20.0%
ROE	36.5%	-5.0%	2.1%	9.5%	13.2%
ROA	12.8%	-0.3%	2.8%	9.6%	15.8%
EV/EBITDA (x)	7.9	66.8	21.3	4.7	2.3
EV/EBIT (x)	9.1	-429.9	29.8	6.8	3.0
Financial Structure					
Current Ratio (x)	2.5	0.3	5.3	1.8	2.0
Quick Ratio (x)	2.4	0.1	5.1	1.6	1.8
Debt/Equity	181.7%	231.1%	30.3%	28.0%	25.1%
Net Debt ($m)	41.7	55.1	-0.7	-5.4	-30.2
Net Debt/Equity	179.9%	230.7%	-0.6%	-4.8%	-23.9%
Net Interest Cover (x)	-1.9	-0.1	1.1	15.9	27.6
NTA ($m)	23.2	23.9	104.3	112.8	126.2
NTA per share ($)	0.08	0.08	0.15	0.16	0.18
Cashflow					
Cash flow per share ($)	-0.06	0.03	0.01	0.05	0.05
P/CFPS (x)	-2.4	4.8	19.4	2.8	2.6
Share Data					
Issued shares (m)	293.8	308.0	700.3	700.3	700.3
Diluted weighted ave (m)	293.8	309.1	402.7	701.4	701.4
Diluted EPS (cents)	2.88	-0.4	0.5	1.5	2.4
EPS change	70.5%	-113.5%	237.4%	185.4%	56.5%
PE (x)	4.7	na	25.3	8.9	5.7
Dividend (cents)	0.00	0.00	0.00	0.31	0.48
Dividend Yield	0.0%	0.0%	0.0%	2.3%	3.5%
Franking (%)	100%	100%	100%	100%	100%
EV ($m)	81.3	96.7	93.9	89.1	64.3

Valuation

Discounted Cash Flow		
Cost of Equity		15.10%
Cost of Debt		8.50%
WACC		12.36%
Target Debt/Equity		30%/70%
Terminal Growth Rate		3.00%
Value Per Share		**$0.28**
PE target	9.3	$0.14
Price target (average)		**$0.21**

Board of Directors

Name	Position
Xue Yongwen	Non-executive Chairman
Chen Lidong	Chief Executive Officer
Peter Carroll	Non-executive Director
Paul Frederiks	Executive Director
Sherman Tan	Non Executive Director
Damien Seah	Alternate to Xue Yongwen
Lanson Lim	Alternate to Chen Lidong

Substantial shareholders	% holding
China Powerplus Limited	46.3
Jadefield Group Limited	46.3

Disclosure

RCAN0864

This Research report, accurately expresses the personal view of the Author.

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Declaration

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The recommendation made in this report is valid for four weeks from the stated date of issue. If in the event another report has been constructed and released on the companies mentioned in this report, the new recommendation supersedes this and therefore the recommendation in this report will become null and void.

Recommendation Definitions
BUY – 10% or more outperformance
ACCUMULATE - 10% or more is contingent on entry price and suggests exploiting any share price weakness
HOLD – 10% underperformance to 10% over performance
SELL – 10% or more underperformance
Period: During the forthcoming 12 months, at any time during that period and not necessarily just at the end of those 12 months.

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