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Company Update 18 January 2011

Malaysia Steel Works (KL)

- Upbeat domestic demand outlook for steel bars
- Some uncertainties in global steel market
- But earnings expected to trend higher in 2011-2012
- Very attractive valuations 6x 2011E P/E and 0.6x NTA

BUY

Key stock statistics	2009	2010E
EPS (sen)	-4.4	15.3
P/E (x)	nm	8.7
DPS (sen)	1.0	1.5
NTA/share (RM)	2.14	2.28
Issued capital (mil)	210.8	
52-week price range (RM)	0.825-1.35	

Major shareholders (%)

Soon Seng Co 38%

Price
RM1.34

Market capitalization
RM261 million

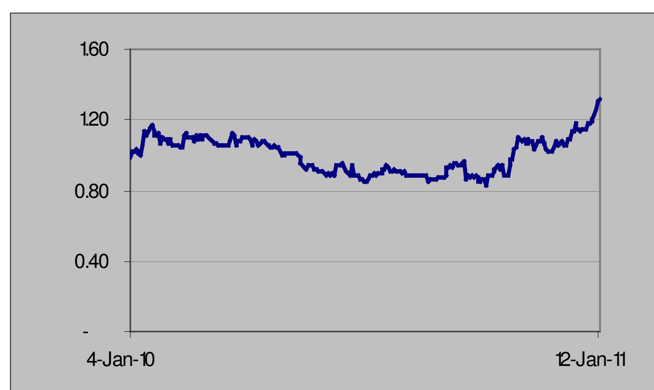
Board
Main

Sector
Industrial Products

Stock code
5098

Analyst
Linda Koh

Share Price Chart



Recent Developments

Like all steel players in the country, Malaysia Steel Works (Masteel) went through a steep down cycle amid the global financial crisis – and is currently in the early stages of a recovery.

After reporting record net profit of RM79.3 million in 2008, the company fell deep into the red in 1H09 on the back of a collapse in both the demand and selling prices for steel related products.

Although market conditions improved in 2H09, Masteel ended that year with a net loss of RM8.5 million. Having said that, it was still a comparatively good set of results.

Clearly, being one of the smaller steel operators has its advantages in terms of production flexibility and lower overheads. The company has also proven to be fairly astute in terms of seeking out niche markets and managing its stock levels.

Demand and steel prices gradually strengthened through the first half of 2010. The global economy rebounded smartly, boosted by massive government stimulus packages and extremely loose monetary policies as well as inventory rebuilding.

Masteel reported a strong 43% y-y sales growth in 1H10. But rising cost of raw materials weighed on margins. Net profit totaled RM14.4 million, much improved from the net loss of RM32.4 million in the previous corresponding period, during the worst of the crisis, but was down from the RM23.9 million in 2H09.

The nascent demand recovery was still too weak for steel millers to sustain higher selling prices. Prices for steel bars trended higher through the first few months of the year but gave back most of its gains in 2H10.

Indeed, the steel sector recovery continued to be uneven with weakening demand and rising costs pushing some of the bigger players into the red again in 3Q10. In this respect, Masteel, again, fared well compared with its peers.

The company actually reported better underlying earnings for the quarter although net profit was affected by one-off charges totaling RM9.7 million, which consisted of write-off for its bond investment and loss on disposal of a 55% stake in its biotech venture. (Masteel has since completely repaid the RM50 million loan that was associated with the bond investment).

We believe the better than industry performance in 3Q10 was due to the company's shorter inventory cycle. Most of the larger players were caught with higher priced raw materials secured in early-2Q10.

For the first nine months of 2010, sales for Masteel totaled RM712.8 million, up 44% from the previous corresponding period while net profit totaled RM19.2 million, a reversal from the net loss of RM19.1 million recorded over the same period.

The company will be releasing its results for the final quarter of 2010 sometime in late-February 2011. We expect sales and net profit to be roughly around the same level as that achieved in 3Q10, but without the one-off charges. That would bring net profit for the full-year to about RM32.3 million, after taking into account the RM9.7 million in one-off losses.

Earnings outlook

For the current year, outlook for the steel sector is cautiously optimistic, though still somewhat hazy.

Whilst demand is likely to keep improving as the global economic recovery gains traction, there are still potential headwinds. Furthermore, strong demand for raw materials and constricted supply over the next few months, at least, is expected to drive costs higher.

With the still ample surplus steel making capacity in the world, steel makers may not be able to fully pass on rising costs. Thus, whilst topline sales are expected to expand, margins and earnings growth are less certain.

Domestic demand expected to pick up steam

Demand for steel bars in the domestic market is expected to gradually strengthen, especially towards the later half of this year and going into 2012-2013.

In addition to some RM49.2 billion allocated for development expenditure under the Budget 2011 – for hospitals, schools, infrastructure, etc – some RM12.5 billion of the 52 high impact projects under the Private-Private Partnership (PPP) initiative are to be implemented this year. The latter includes several highways, oil & gas facilities and a coal-fired power plant.

We could also see some of the recently announced large-scale projects kick off later in the year, including the RM36 billion mass rail transit (MRT) system for the Klang Valley and the first phase of the light rail transport (LRT) extension.

Some of the other development projects on the drawing board include the RM10 billion Sungei Buloh mixed development on the 3,300-acre Rubber Research Institute land and the RM5 billion Warisan Merdeka development, which will be undertaken by the EPF and PNB, respectively, as well as the RM26 billion KL International Financial District project.

In January 2011, the government identified another 19 projects under the Economic Transformation Programme worth some RM67 billion.

Thus, we expect volume demand for building materials such as steel bars to register fairly good growth for the next few years.

Outlook for steel prices less clear

On the other hand, the outlook for steel prices is less clear. Local steel makers have raised steel bar prices earlier this month primarily due to higher costs rather than improved demand.

Steel bars are currently selling for around RM2,200-RM2,300 per tonne, compared with the average of just over RM2,000 per tonne in 4Q10 and RM2,100 per tonne in 2010.

Nevertheless, we remain cautious on whether the recent price hike will stick. As mentioned above, steel makers have tried to push prices higher in 1H10 but the move eventually proved unsustainable.

To be sure, the prospects are better this time around on the back of expectations for strengthening domestic demand. On the other hand, developments in the global steel market may yet influence the direction of local prices.

Improved global outlook but potential pitfalls remain

For the moment, global steel prices are being supported by rising input costs, including that for fuel, iron ore and coking coal.

The quarterly contract prices (roughly based on average spot prices for the preceding three months) for iron ore inched higher in 1Q11 after dipping in 4Q10 – and are expected to rise further in 2Q11 on tight supplies.

Exports from India have reduced in recent months while new supplies are not expected to come onstream until end-2011. Spot prices for iron ore have risen to around US$180 per tonne in recent days, compared with the contract price of roughly US$130-US$140 per tonne in 4Q10-1Q11.

Coking coal prices too have surged in the spot market, driven by the supply disruption in Australia where the worst flooding in decades has resulted in miners declaring force majeure on their contracts. The flood-affected areas are estimated to account for up to a quarter of the world's output for coking coal. Some expect prices to hit US$300 per tonne in the coming months, compared with the contract price of US$225 per tonne in 1Q11.

Prevailing steel prices are also supported, in part, by stocking up on expectations of even higher prices in the coming months. But the market could still sour quickly if demand growth fails to meet expectations.

The World Steel Association estimates steel demand growth will moderate to 5.3% this year, from the growth forecast of 13.1% in 2010.

Despite the prevailing upbeat outlook, there are headwinds for the global economy.

The sharp rebound in 2009-2010 was spurred by massive stimulus programmes and inventory rebuilding, the effects of which will fade this year. Although consumer confidence is up, businesses are still, by and large, reluctant to spend. It remains to be seen if private consumption can grow fast enough to offset the drop in public spending. In particular, austerity plans in Europe and policy tightening in China will start to bite.

The average utilisation rate for global steel makers has fallen back to around 75% at end-2010, down from a high of almost 83% in April 2010. Intense competition for customers may keep the pressure on prices – despite rising costs. This will be particularly telling should there be a shortfall to prevailing demand growth expectations.

The steel industry in China, for example, remains fragmented despite the government's efforts to consolidate and close outdated plants. The country's demand growth is likely to cool somewhat with prevailing tightening policies. That raises the risks of cheap exports given that the industry remains in an overcapacity situation.

Malaysia's imports of steel bars are fairly negligible at the moment. However, following our own government's liberalization measures, local producers will have to be wary of competition from imports. The stronger ringgit exacerbates competition, making for even "cheaper" imports.

Help from the government?
Local steel millers, via the newly formed Malaysia Steel Association, are in discussions with the government on various proposals to help buffer against rising costs.

These include the possibility of reinstatement of the 5% import duty on steel bars, higher duty on the export of iron ore and scrap steel, as well as the allocation of economic sized land for mining activities. The steel manufacturers are also proposing to extend off-peak electricity rates to weekends and public holidays.

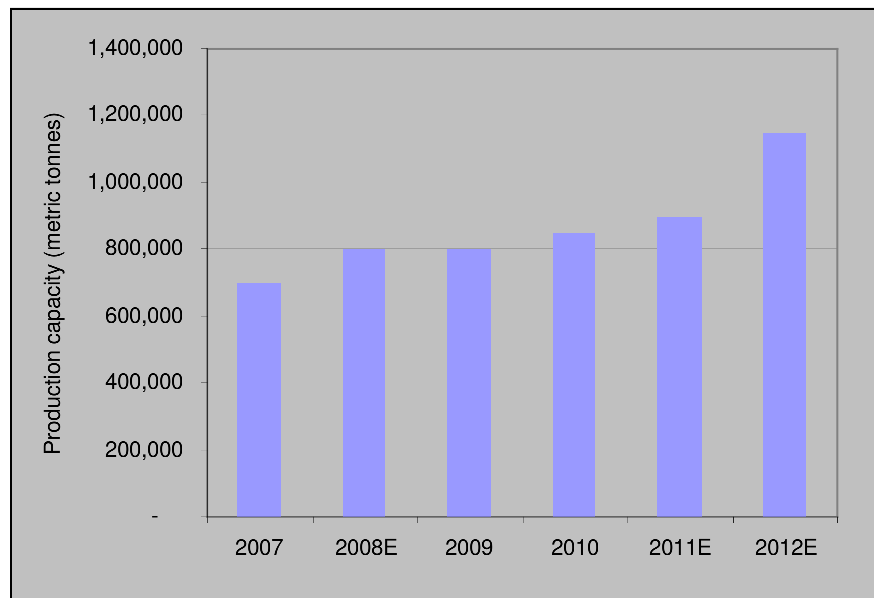
Expand capacity to cater to rising volume demand
On balance, we expect to see continued improvement in volume demand for steel bars but margins and earnings for steel makers may gyrate amid heightened cost inflation and competitive pressure. Nevertheless, given its good track record, we expect Masteel will continue to navigate any price volatility well.

Masteel expects its topline sales to expand, underpinned by improvement in domestic demand.

Indeed, the company is planning to expand its rolling mill capacity to cater to the expected demand growth from the government's announced development and infrastructure projects. It is in the midst of evaluating the acquisition of a rolling mill. If all goes to plan, the move will add an additional 150,000 metric tonnes to its annual production capacity by 2012.

It is also planning to boost its meltshop capacity (feedstock for the rolling mill) to about 650,000 metric tonnes over this period. Capital expenditure is estimated at around RM100 million for the proposed capacity expansions over the next two years.

At present, the utilisation rates at its meltshop and rolling mill have improved to roughly 80% and 85%, respectively.



The company raised about RM35.4 million last year from a private placement of 16.1 million shares and rights issue of warrants to shareholders on the basis of one warrant for every two shares held.

Even so, gearing will rise with the planned capex, from the 46% at end-3Q10 where net debt totaled RM206.8 million. However, we expect it to remain within relatively comfortable range. We estimate gearing to rise to roughly 67% by end-2012. This is still fairly low compared with the gearing levels for most of its peers in the sector.

Valuation and Recommendation

We forecast the company's net profit to improve to RM47.3 million and RM57.3 million for 2011-2012, respectively. Based on our earnings estimate, the stock is now trading at modest P/Es of roughly six and five times for the two years, respectively – well below prevailing average valuations for the sector.

Its share price also remains well below net assets of RM2.14 per share at end-3Q10. As such, we are inclined to recommend a **BUY** on the stock.

Masteel has some 105.4 million warrants outstanding. The warrants have a five-year maturity period and exercise price of 67 sen and are currently trading at 80.5 sen.

Valuations comparison

	Price (RM)	2011E EPS (sen)	P/E (x)	P/NTA (x)	Gearing (%)
Lion Industries	2.12	19.2	11.0	0.5	3%
Southern Steel	2.18	28.6	7.6	1.2	81%
Kinsteel	0.92	6.3	14.7	1.1	219%
Masteel	1.34	22.4	6.0	0.6	46%
Ann Joo Resources	3.08	40.5	7.6	1.6	124%
Perwaja	1.07	8.9	12.0	0.6	104%
Simple sector average			9.8	0.9	

Recap on company profile

Masteel is one of five vertically integrated steel millers in the country. The company was founded by the Tai family, which remains firmly in control of the business via a 38% stake held by Soon Seng Co. It was listed on the Bursa Malaysia in February 2005.

Pursuant to a bonus issue and private placement exercises, Masteel's share capital was enlarged to the current 210.8 million shares of 50 sen par value, from 133 million shares on listing. The company has a market capitalisation of RM261 million at the current share price of RM1.34.

Masteel owns and operates an electric arc furnace to manufacture steel billets. Currently, the meltshop has an annual capacity of 500,000 metric tonnes. The primary feedstock used is scrap steel, which is sourced both locally and imported.

The billets produced are, in turn, used as feedstock at its rolling mill to produce high tensile steel bars, primarily for the construction sector. The rolling mill has a capacity totaling 350,000 metric tonnes at end-2010. Depending on market conditions, Masteel may also export its billets to neighboring countries.

The bulk of the steel bars produced are sold in the domestic market through dealers and trading houses. Over the past year, the company has also been exporting to Australia and New Zealand – after its products received Certification of Product Compliance from the Australian Certification Authority for Reinforcing Steels (ACRS), an accreditation accepted in both countries. Exports accounted for roughly 12% of sales last year.

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Profit & Loss Analysis

Year end Dec (RM mil)	2008	2009	2010E	2011E
Turnover	881.2	687.3	996.5	1,146.0
Operating profit	114.6	21.8	74.7	86.0
Depreciation	15.1	16.2	15.9	14.9
Interest inc/(exp)	(13.8)	(14.1)	(15.1)	(18.5)
EI loss/(gain)	-	-	9.7	-
Pre-tax profit	85.7	(8.4)	34.1	52.5
Tax	6.4	0.0	1.7	5.3
Minority Interests	-	-	-	-
Net profit	79.3	(8.5)	32.3	47.3
EBITDA margin (%)	13.0	3.2	7.5	7.5
Pre-tax margin (%)	9.7	(1.2)	3.4	4.6
Net margin (%)	9.0	(1.2)	3.2	4.1
Effective tax rate (%)	7.5	(0.3)	5.0	10.0

Per Share Data

Year end Dec	2008	2009	2010E	2011E
EPS (sen)	40.7	(4.4)	15.3	22.4
P/E (x)	3.3	(30.8)	8.7	6.0
Dividend (sen)	2.5	1.0	1.5	2.0
Net yield (%)	1.9	0.7	1.1	1.5
Payout ratio (%)	6.1	(23.0)	9.8	8.9
NTA/share (RM)	2.21	2.14	2.28	2.49
Price/NTA (x)	0.6	0.6	0.6	0.5
Cashflow/share (RM)	0.49	0.02	0.40	0.29
Price/cash (x)	2.7	64.6	3.4	4.5
Net gearing (%)	51.9	53.0	54.5	58.7
ROE (%)	20.1	(2.0)	7.2	9.4

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