HLIB Research

PP 9484/06/2010 (024855)

Malaysian Steel Works (Not Rated)

BRIEFING NOTE **January 24, 2011**

SECTOR: OVERWEIGHT **Share price: RM1.41**

Diversifying Away from Steel Business

News

- Masteel entered into 60:40 JV with KUB to bid for a RM1.35bn project to build and operate a 106.5km inter-city rail transit system in Iskandar Malaysia. The JV project will be divided into two components, which include: (1) Build-transfer of the rail transit infrastructure; and (2) Upon the completion of the project, the JV entity will then lease back the assets from the Federal Government and operate for 25 years.
- Component #1: Construction is expected to commence once the details are finalized (expected by 3Q 2011) while the project is expected to complete within 24 months. Management reveals that the project involves little or no land acquisition cost and expects a net margin of 8% from the construction of this project.
- Component # 2: Upon the completion of the project (to be undertaken in 3 stages and expected by end 2013), the JV entity operate this assets by leasing it back from the Federal Government for a total lease rental of RM515m over 25 years and management expects an IRR of 8-13% from this new venture.

Risks

Downside risks: (1) Overcapacity in China remains over longer term; (2) Volatile input prices, making the sector a play on short-term potential price trend; (3) Influx of steel at cheap prices; and (4) Delay in the implementation of large scale infrastructure projects under ETP and 10MP.

Forecasts

- Management is projecting FY12/10-11 net profit to turnaround to a net profit of RM29m and RM52m respectively from a net loss of RM8.1m in FY12/09.

Rating

Not Rated

- Positives – (1) Improving steel sector outlook; (2) Potential rollout of more large-scale projects will likely boost domestic steel consumption; (3) Reduced concerns on overcapacity; and (4) Low valuation.
- Negative – Low share liquidity

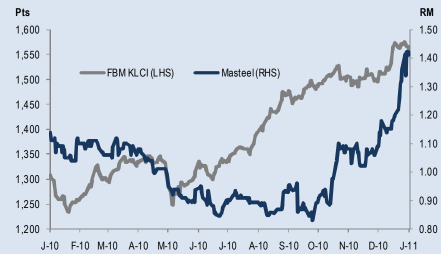
Valuation

- Based on management's projected FY12/11 net profit forecast of RM52m (and fully-diluted EPS of 17.8 sen), Masteel is trading at FY12/11 P/E of 7.9x, which is higher than its local peers' average CY2011 P/E of 7.3x due to management's bullish forecast.

Chye Wen Fei
wfchye@hlib.hongleong.com.my
(603) 2168 1080

KLCI	1,547

Share Price



Information

Bloomberg Ticker	MSW MK
Bursa Code	5098/ MASTEEL
Issued Shares (m)	210.8
Market cap (RMm)	297.2
3-mth avg daily volume ('000)	1,490

Price Performance	1M	3M	12M
Absolute	23.7	54.1	27.0
Relative	21.5	50.3	8.0

Major shareholders

TYY Resources	30.4
Lembaga Tabung Haji	8.9
Bin Dato Hj S Ikhwan Salim	4.8

Summary Earnings Table

FYE Dec (RM m)	2008A	2009A	2010F	2011F
Turnover	881.2	687.3	1,000.0	1,135.0
EBIT	99.5	5.4	N/A	N/A
Pre-tax Profit	85.7	(8.5)	32.0	58.0
Net profit	79.3	(8.1)	29.0	52.0
FD EPS (sen)	37.6	(3.8)	10.5	17.8
P/BV (x)	0.7	0.7	N/A	N/A
Net Gearing	0.4	0.5	N/A	N/A
ROE (%)	18.4	(1.9)	N/A	N/A
ROA (%)	10.8	(1.1)	N/A	N/A
Book Value (RM)	2.0	2.0	N/A	N/A

Masteel

Highlights

Malaysia Steel Works (Masteel) shared more details on the head of joint venture agreement signed with KUB Malaysia Bhd to build and operate a 106.5km inter-city rail transit system in Iskandar Malaysia that connects to the MRT line in Singapore. The JV project (where both Masteel and KUB will hold equity stake of 60% and 40% respectively) will be divided into two components, which include: (1) Build-transfer of the rail transit infrastructure; and (2) Upon the completion of the project, the JV entity will then lease back the assets from the Federal Government and operate for 25 years.

Component #1: Build-transfer of rail transit infrastructure

The construction of the RM1.35bn inter-city rail transit system that links between Iskandar Malaysia and Singapore (106.5km, see Figure 1) is expected to commence once the details (pertaining to the design, concession, etc) are finalized (expected by 3Q 2011) while the project is expected to complete within 24 months. Management reveals that the project involves little or no land acquisition cost as it will utilize the existing Keretapi Tanah Melayu Bhd's (KTMB) railway track and land reserve. Based on our estimates, we believe the construction of this project will enhance its bottomlines by an average of RM32.4m p.a., assuming:

1. 8% net profit margin as guided by Masteel's management;
2. Construction of the project to commence in early-2012 and complete by end-2013; and
3. Total construction cost of RM1.35bn.

Figure 1: Project Feature

Route	
Kulai – JB Mainline (11 stations)	32.0km
Pasir Gudang – PTP (13 stations)	65.0km
Senai Spur (2 stations)	8.0km
JB Sentral – Woodlands (1 station)	1.5km
Total	**106.5km**

Masteel

Figure 2: Project Costing

		RMm
Estimated construction & supply price		
-	Rolling stock & infrastructure	320
-	Track works – Senai spur line	180
-	Ticketing, electrification, signaling & Kempas maintenance yard	850
Total		1,350
Project funding		
-	Funding by JV promoters	70
-	Facilitation fund by Public Private Partnership	1,030
-	Proposed bond issuance	250
		1,350

Masteel

Component #2: Build-transfer of rail transit infrastructure

Upon the completion of the project (to be undertaken in 3 stages and expected by end 2013), the JV entity will operate this assets by leasing it back from the Federal Government for a total lease rental of RM515m over 25 years. Upon the completion of the first phase of this project, Masteel projects that there will be 26.3m passenger using the commuter train system and it expects the completion of the second phase of the project, i.e. the extension of the commuter train system from Johor Bahru to Woodlands, Singapore will bring in another 22m cross-border commuters (equivalent to roughly 10% of the current cross-border commuters). Depending on the finalization of the concession agreement with the Federal Government (either similar to the structure of the toll concession agreement in Malaysia or on “free market basis”, which the ridership charge is based on demand-supply), management expects an IRR of 8-13% from this new venture.

Bullish on steel

Latest development aside, management is upbeat on the steel sector and it projects that its profitability in FY12/11 will return to FY12/07-08 levels, underpinned by higher steel prices and better demand arising from the implementation of large infrastructure projects under the Economic Transformation Program (ETP) and 10 Malaysia Plan (10MP).

Risk(s)

Risks for the steel operations include: (1) Overcapacity in China remains over longer term; (2) Volatile input prices, making the sector a play on short-term potential price trend; (3) Influx of steel at cheap prices; and (4) Delay in the implementation of large scale infrastructure projects under ETP and 10MP.

Forecasts

Management is projecting FY12/10-11 net profit to turnaround to a net profit of RM29m and RM52m respectively from a net loss of RM8.1m in FY12/09 mainly underpinned by: (1) Higher sales volume; (2) Better profit margin arising from higher steel prices (we note that management has yet to taken into account of the potential construction profit from the rail transit project mentioned above).

Valuation

Based on management’s projected FY12/11 net profit forecast of RM52m (and fully-diluted EPS of 17.8 sen), Masteel is trading at FY12/11 P/E of 7.9x, which is below its local peers’ average CY2011 P/E of 7.3x (see Figure 3) despite management’s bullish forecast. We believe the proposed commuter train system, if it realizes, will be a re-rating catalyst to Masteel’s share price, as this diversify Masteel from the current core operations (i.e. steel) into concession-based business (that will provide stable income to the company over the longer term). However, we believe there are still several milestones to achieve before a re-rating could happen, such as letter of award issued by the Government, the finalization of the concession agreement, execution risk due to lack of track record etc.

Figure 3: Domestic Peer Comparison

	Share Price	EPS (LC)		P/E (x)		P/Book (x)	
		CY10	CY11	CY10	CY11	CY10	CY11
Ann Joo Resources	3.04	0.31	0.36	10.0	8.5	1.7	1.5
Kinsteel	0.96	0.07	0.10	14.1	9.2	1.1	1.0
Lion Industries	2.02	0.51	0.42	4.0	4.8	0.5	0.4
Southern Steel	2.29	0.31	0.35	7.4	6.6	1.1	0.9
				8.9	7.3	1.1	0.9

Source: Bloomberg; HLIB

Disclaimer

1. As of 24 January 2011, Hong Leong Investment Bank Berhad has proprietary interest in the following securities covered in this report:
(a) -.

2. As of 24 January 2011, the analyst, Chye Wen Fei who prepared this report, has interest in the following securities covered in this report:
(a) -.

Published & Printed by
Hong Leong Investment Bank Berhad **(43526-P)**
Level 8, Menara HLA
No. 3, Jalan Kia Peng
50450 Kuala Lumpur
Tel 603 2168 1168 / 603 2710 1168
Fax 603 2161 3880

Equity rating definitions

BUY	Positive recommendation of stock under coverage. Expected absolute return of more than +10% over 12-months, with low risk of sustained downside.
TRADING BUY	Positive recommendation of stock not under coverage. Expected absolute return of more than +10% over 6-months. Situational or arbitrage trading opportunity.
HOLD	Neutral recommendation of stock under coverage. Expected absolute return between -10% and +10% over 12-months, with low risk of sustained downside.
TRADING SELL	Negative recommendation of stock not under coverage. Expected absolute return of less than -10% over 6-months. Situational or arbitrage trading opportunity.
SELL	Negative recommendation of stock under coverage. High risk of negative absolute return of more than -10% over 12-months.
NOT RATED	No research coverage, and report is intended purely for informational purposes.

Industry rating definitions

OVERWEIGHT	The sector, based on weighted market capitalization, is expected to have absolute return of more than +5% over 12-months.
NEUTRAL	The sector, based on weighted market capitalization, is expected to have absolute return between –5% and +5% over 12-months.
UNDERWEIGHT	The sector, based on weighted market capitalization, is expected to have absolute return of less than –5% over 12-months.