KENANGA RESEARCH

Initiating Coverage

Malaysia Steel Works

"Steel" Hot

BUY

Price: RM1.18
Target Price: RM1.69

STOCK DATA

Bloomberg Ticker	MSW MK	YTD price chg	2.6%
Market Cap	248.7	YTD KLCI chg	1.9
Issued shares	210.8		
52-week range (H)	1.60	**Major Shareholders**	
52-week range (L)	0.83	TYY Resources SB	31.8%
3-mth avg daily volume	1,443,459	LTH	5.2%
Free Float	59.5%	Datp Hj S Ikhwan	3.5%

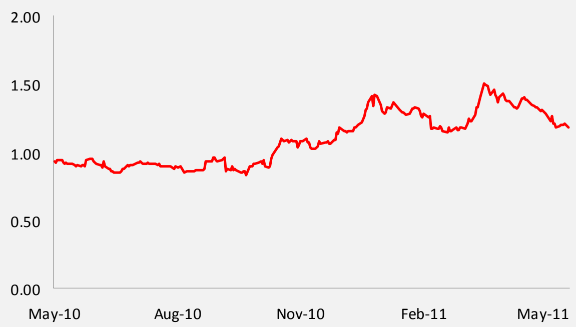
FINANCIAL HIGHLIGHTS

FYE 31 Dec	2008	2009	2010	2011E	2012E
Turnover	881.2	687.3	1004.8	1118.7	1243.0
EBIT	100.3	5.6	32.2	66.3	83.7
Pretax profit	85.7	-8.4	30.1	50.2	65.1
Core Net Profit	79.3	-8.5	42.2	47.0	60.9
EBIT margin	11.4%	0.6%	3.7%	7.5%	9.5%
Pretax margin	9.7%	-1.0%	3.4%	5.7%	7.4%
Effective tax rate	7.5%	-0.3%	6.3%	6.3%	6.3%
Growth ratios					
Turnover	60.8%	-22.0%	46.2%	11.3%	11.1%
EBIT	62.1%	-94.4%	474.0%	106.1%	26.2%
Pretax profit	85.6%	-109.9%	456.1%	66.7%	29.7%
Core Net profit	78.8%	-110.7%	598.1%	11.4%	29.7%
ROE	20.2%	-2.0%	9.4%	9.4%	11.2%
ROA	11.5%	-1.1%	5.4%	5.5%	6.7%
Net Gearing (x)	0.5	0.5	0.4	0.4	0.3
Per share data					
Core EPS (sen)	40.7	-4.4	20.0	20.3	24.1
EPS growth (%)	78.8%	-110.7%	560.0%	1.3%	18.9%
PER (x)	2.9	-27.1	5.9	5.8	4.9
Gross DPS (sen)	3.3	0.0	0.0	0.0	0.0
Div. Yield (%)	2.8%	0.0%	0.0%	0.0%	0.0%
NTA/share (RM)	2.2	2.1	2.3	2.2	2.3

Historical price ratio

(X)	2008	2009	2010	2011E	2012E
Price /Earnings	2.9	-27.1	5.9	5.8	4.9
Price /Book	0.5	0.6	0.5	0.5	0.5

SHARE PRICE CHART



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Masteel is poised to benefit from the multiple construction and property projects around Klang Valley area. With its plant strategically located in Klang Valley coupled with aggressive expansion plans, Masteel will be able to deliver orders for its long steel products with higher time and product turnover rates. We projected net earnings of RM47m and RM60.9m for FY11 and FY12, respectively with the assumptions of new order flow from local steel demand as a result of the prospective ETP construction works in the near term. With a 37% potential upside we initiate coverage on Masteel with BUY and target price at RM1.69 based on 7x PE on FY12 EPS.

Strategically located. Klang Valley, the fastest developing area in Malaysia which consumes highest steel products in the country on the back of robust construction and infrastructure works. In general, steel makes up 10%-20% of total construction's cost and with a massive MRT project roll out could bring enormous spill over impacts to demand for steel products. Masteel would be able to leverage on its strategically located meltshop in Klang and rolling mill in Petaling Jaya for lower mobilisation cost and timely delivery of steel products to construction sites. On the supply side, its plant location proximity to Port Klang will help to speed up logistic for its imported feedstock ie: steel scrap while providing easy access to export its billets product.

Inter-city rail transits network a bonus. Although the earnings contribution from the inter-city rail transit network project in Iskandar Malaysia is relatively far muted, we see the immediate earnings contribution would be the demand for its steel bars. Going forward, the rail project should provide recurring income to the JV company riding on projected 132,255 commuters per day. However, we do not account for the JV company contributions in our forecast and valuation.

Susceptible to high commodity prices. Masteel is not an exception to the whims of steel and scrap price cycles. Nevertheless, Masteel's active inventory management could partly cushion the impact for any possible down cycle since it has shorter inventory days of c.80 days as opposed to peer average of 120 days, which have reduced its holding costs.

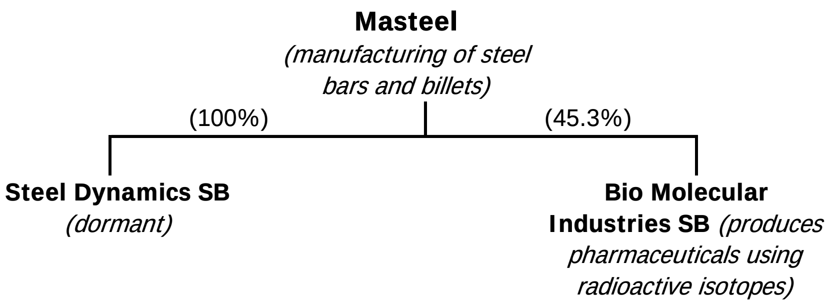
Potential demand from construction job flows under ETP. We expect Masteel to register net earnings of RM47m and RM60.9m for FY11 and FY12 respectively, pinned by the potential demand from construction job flows under the ETP and new property launches as well.

Initiate with BUY. We initiate coverage on Masteel with BUY and target price of RM1.69. Our Target Price is based on the average of **7x FY12 PER which is a 20% discount to its peer average of 9x.** Masteel is currently trading at 5.8x forward PE, a 37% discount to the peers.

Company Overview

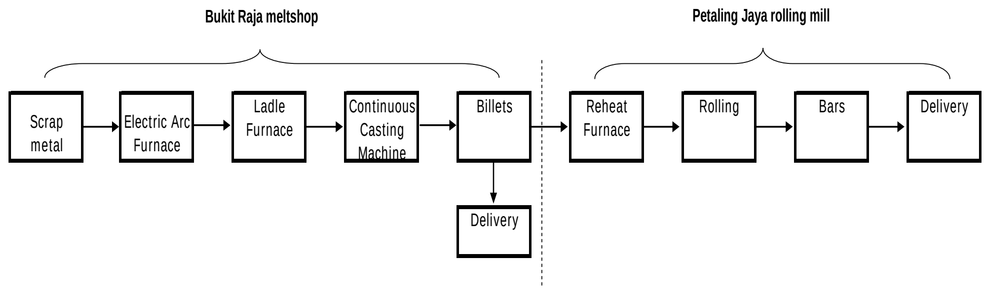
Installed capacity of 550,000MT of billets per annum. Malaysia Steel Works (Masteel) operation started back in 1971, which produces commercial grade mild steel round bars, steel billets at its rolling mill in Petaling Jaya, Selangor. At present, Masteel is one of the top five integrated steel mills in Malaysia with a fully continuous mill in Petaling Jaya, with reheating furnace capacity at 350,000mt p.a. Meanwhile, Masteel also operates an electric arc furnace billet plant, which is located in Bukit Raja, Klang with a production capacity of 500,000mt of billets per annum. The steel billets products will be channelled to its rolling mill in Petaling Jaya as a feed stock for steel bars.

Masteel's corporate structure



Source: Company Data/ Kenanga Research

Masteel's Integrated Production Flow



Source: Kenanga Research

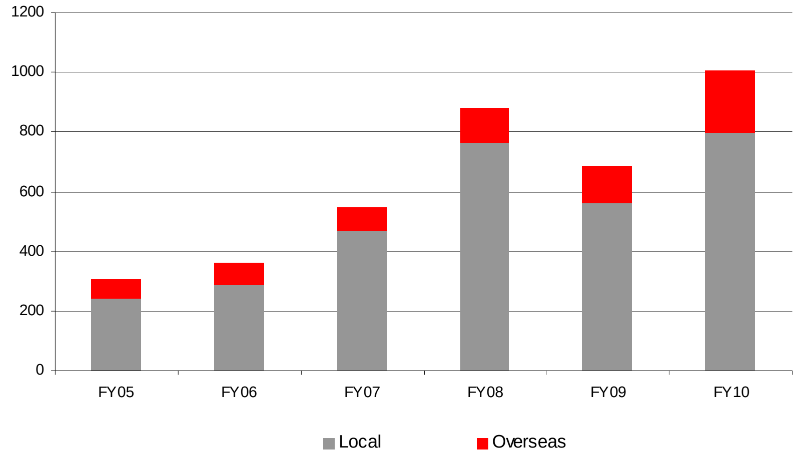
Masteel's Production Facilities

Product	Usage	Production capacity (ton per year)	Utilisation rate (%)
Billets	Raw material for steel bars	500,000	70%
High Tensile Deformed Bars	Concrete structures & buildings	350,000	75%
Mild Steel Round Bars	Light structure construction		

Source: Company Data/ Kenanga Research

Wide range of products. Masteel is mainly involved in the manufacturing and marketing of high tensile steel bars, mild steel bars and prime steel billets. It distributes its product locally via a network of more than 60 dealers nationwide and exports c. 20-30% of its products to Australia, Singapore, New Zealand, Fiji, Vietnam, Philippines, Thailand and Bangladesh. Aside from its steel business, it also has a side business under Bio Molecular Industries SB, which does manufacturing; research and development of radio-isotopes and radio-pharmaceutical products for Positron Emission Tomography (PET) in Sepang. It has recently pared down its stake to 45.3% from 100%. So far, there is no contribution from this venture since announced in 2007, we believe it may take a longer gestation for the venture to be fruitful considering the new technology in Malaysia and neighbouring countries.

Revenue Breakdown by Geography from FY05-FY10



Source: Company Data/ Kenanga Research

Strong management. The company is led by its Managing Director, Dato' Sri Tai Hean Leng, who has more than 20 years of experience in the industry. He has also led the commissioning of the meltshop in Klang. So far, Masteel has been producing a set of good earnings track records aside for a net loss in 2009, which has hit most steel players. Furthermore, under his leadership, Masteel has increased its utilization rate and production numbers from 450,000mt to 650,000mt per annum by 2012. We believe his service will continue to propel Masteel to higher heights.

Catalysts

JV of Masteel and KUB for the 100km inter-city rail transit network project. One of the catalysts is the approved 100km inter-city rail transit network project in Iskandar Malaysia, via Metropolitan Commuter Network SB, which is 60% owned by Masteel and 40% by KUB. The project has 2 portions, namely the "built-transfer" of infrastructure and "own-operate" of the rail transit system, and it is estimated to cost more than RM1b. The project is to be undertaken in 3 phases and expected to be completed within 24 months from the project's commencement; with a 25-year concession. It will consist of 25 commuter stations in major towns in Iskandar Malaysia, serving all major projects such as the Johor Premium Outlet, Legoland Malaysia, Educity, Hi-Tech Park-Senai, and Lake Hill Resort City, and shuttle service from JB Sentral to Woodlands, Singapore, with a forecasted annual ridership of over 40m people.

Daily and yearly expected train riders

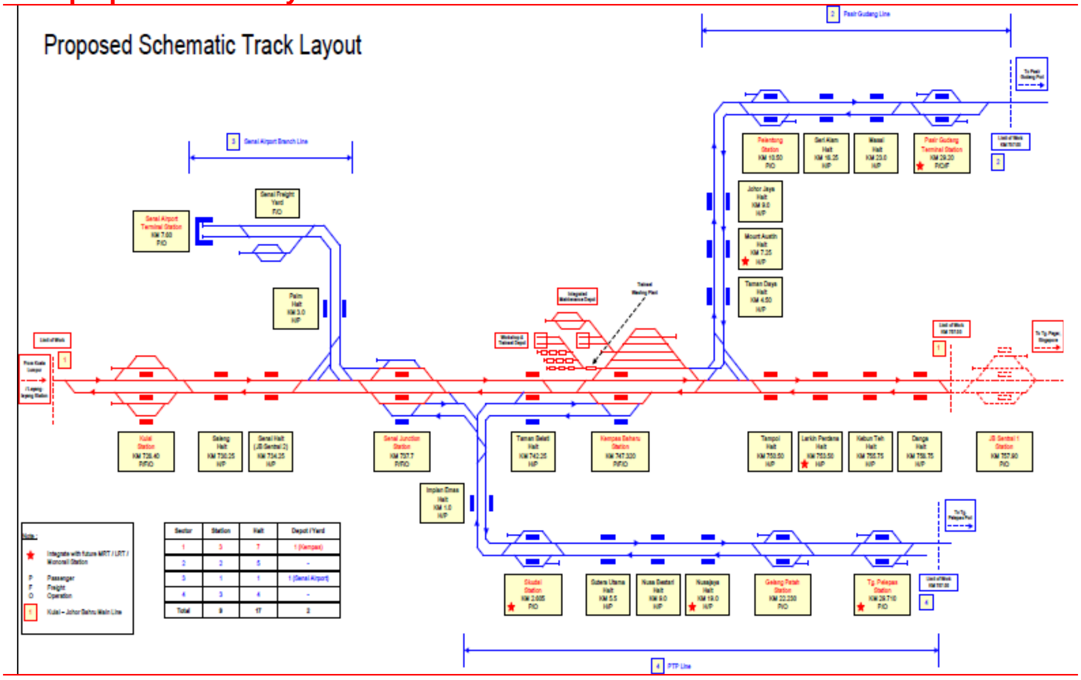
Description	Expected Riders per day	Train Ridership per year
Ridership within Iskandar Malaysia	72,000	26,280,000
Ridership from JB Sentral to Woodsland, Singapore	60,255	21,993,017
Total	**132,255**	**48,273,017**

Source: Company Data/ Kenanga Research

Iskandar Malaysia. To recap, Iskandar Malaysia was one of the country's growth corridors, which span a total of 221,634ha, is modeled after the special economic zone of Shenzhen. By 2025, it is estimated to have a working population of about 1.35m, or 43% of Johor's projected population of 3.17m. The region is expected to attract RM382b flowing into the region by 2025, with manufacturing, property development and tourism earmarked as its key focus.

No immediate impact from the rail project. We do not see immediate earnings contribution from the JV given that the possibility of further delay in the approvals of the project. However, should the approvals is granted by 2011, the first crux of the earnings will only come in by 2013, given the amount of steel bars supplied for the infrastructure and the recurring income from the 25-year concession of the project with a projected annual ridership of 132,255 riders per day. The forecasted profit from the project is c.RM48m (60% of RM80m) for the infrastructure and further RM2.7b sales for the 25-year concession (60% of RM4.5b sales).

The proposed inter-city rail transit



Source: Company Data

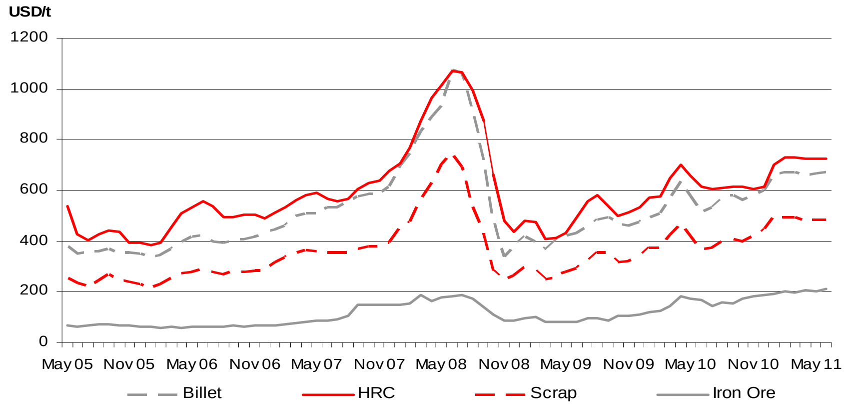
Central location that caters to major projects in Klang Valley. Aside from Lion's Amsteel, Masteel is also strategically located in Klang Valley. Given the strategic location, it will benefit from property and construction projects in Klang Valley as steel generally makes up 10%-20% of total construction costs. Furthermore, Masteel has the logistics advantage as it saves c.RM20 per mt from logistic cost relative to its peers, which are mostly located in North of Peninsula Malaysia. Aside from that, with the proposed KVMRT project, it is estimated to consume 400,000mt of steel for the project. As such, should the actual physical construction of the MRT project kick start end of 2012, the steel orders are expected to come in 2013.

Capacity expansion in preparation for an upsurge in steel orders. After spending some RM60m to RM70m over the past two years to modify its furnace and billet caster, management expects its billet capacity to increase from 450,000mt per year to 650,000mt per year in FY12. Aside from that, its downstream expansion is also on track as the company has identified a plant near its existing rolling mill whereby it requires only minimum modification to convert to a new rolling facility. Management is targeting to increase its rolling capacity to 500,000MT per year by FY12, 42.9% increase from its existing production capacity of 350,000MT per year. With new capacity in place, we are positive on the company's ability to ride on the potential steel orders from the public infrastructure and building projects in the ETP as well as new property launches.

Risks

Cyclical raw material and steel prices. Steel companies' are highly susceptible to the whims of price cycles. Steel companies slipped into the red during a steep contraction in steel prices in 2005 and 2009 as (i) buying sentiment dipped as traders anticipate further price decline, and (ii) the time lag of c.3 months will create a mismatch between higher raw material costs that was stocked in much earlier. Nevertheless, Masteel's active inventory management has partly cushioned the impact for any possible down cycle since it only requires minimal inventory and overheads. Furthermore, high raw material prices, namely iron ore and scrap price will be a major concern for the steel industry. While Masteel is not directly affected by the rising iron ore price given the use of Electric Arc Furnace (EAF), it is at the mercy of volatile scrap prices, which is its main raw material. About 70% of Masteel's total costs of sales is made up of scrap.

Steel and iron ore prices from May'05-May'11



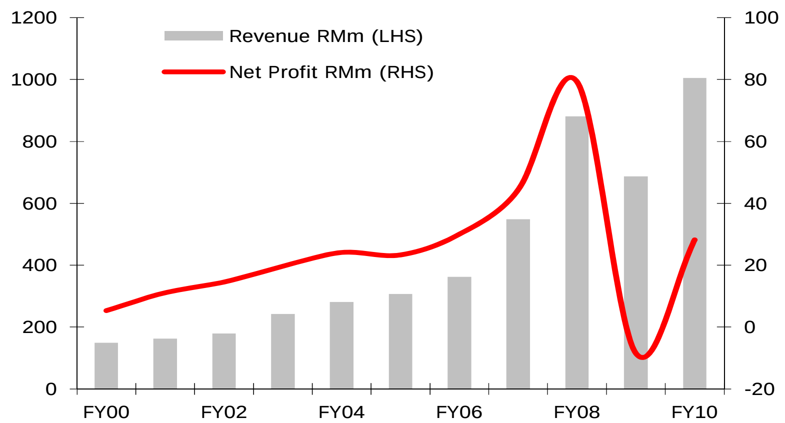
Source: Steel Business Briefing

Electricity tariff hike. Integrated steel producers consume some 750kWh to 900kWh of power per mt for integrated steel production, depending on the plant efficiency plus type of product produced. This translates into c. 6 to 7% of production cost. Assuming non off-peak rate and the recent 7.12% electricity tariff hike, this works out to <1% of the average selling price per mt. Hence, this can be easily absorbed in the event international steel demand recovers.

Financials and Valuations

Fluctuating earnings. Masteel's earnings recorded an average growth of 43.8% from 2001 to 2008 although in 2009, it reported a net loss of RM8.5m, which saw a drastic dip of 110.7% YoY. Steel millers in general, were hit by high raw material prices due to a shortage of supply pursuant to extreme weather. Furthermore, the industry experienced sudden pullback in steel prices in August 2009 which rattled market sentiment as traders held back their purchases. Nonetheless, Masteel still performed better than its bigger peers, which mainly loss making in 2009, thanks to Masteel's effective production management and low overheads. In 2010, the company saw a reversal from net loss of RM8.5m to a net profit of RM28.2m due to pick-up in local steel demand. Going forward, we expect Masteel to register net earnings of RM47m and RM60.9m for FY11 and FY12 respectively, in view of potential higher construction contract flow from the ETP and new property launches. Nonetheless, we did not factor in the earnings contribution from the potential new sales orders from the Iskandar intercity rail network in our forecast.

Revenue and net profit track record



Source: Kenanga Research

Manageable gearing of 0.5x relative to peers. Masteel's balance sheet is relatively healthier than its peers as its gearing ratio stood 0.4x as at FY10 vis-a-vis peers average at 0.1x to 2.3x.

BUY and Target Price of RM1.69. We initiate coverage on Masteel with BUY and Target Price of RM1.69 **based on the average of 7x FY12 PER** which is a 20% discount to the peer average of 9x. We apply a conservative 20% discount to other steel players considering its relatively smaller market capitalization. Masteel is currently trading at 5.8x forward PE, a 37% discount to the peers.

Earnings Estimates

FYE 31 Dec (RMm)	**2008**	**2009**	**2010**	**2011E**	**2012E**
Revenue	881.2	687.3	1004.8	1118.7	1243.0
Pretax profit	85.7	-8.4	30.1	50.2	65.1
Core Net profit	**79.3**	**-8.5**	**42.2**	**47.0**	**60.9**
Core EPS (sen)	40.7	-4.4	20.0	20.3	24.1
EPS growth (%)	78.8%	-110.7%	560.0%	1.3%	18.9%
DPS (sen)	3.3	0.0	0.0	0.0	0.0
NTA/ share (RM)	2.2	2.1	2.3	2.2	2.3
Net gearing (x)	0.5	0.5	0.4	0.4	0.3
PER (x)	2.9	-27.1	5.9	5.8	4.9
P/NTA (x)	0.5	0.6	0.5	0.5	0.5
Net div. yield (%)	2.8%	0.0%	0.0%	0.0%	0.0%
EV/ EBITDA (x)	3.9	20.7	9.3	5.4	4.1
ROE (%)	20.2%	-2.0%	9.4%	9.4%	11.2%

Balance Sheet

FYE 31 Dec (RMm)	**2008**	**2009**	**2010**	**2011E**	**2012E**
Non Current Assets	407.9	431.9	448.3	449.8	452.8
Current Assets	326.6	317.7	378.2	438.4	489.9
Total Assets	**734.5**	**749.6**	**826.5**	**888.2**	**942.7**
Current Liabilities	180.2	214.9	261.5	303.6	326.0
Non Current Liabilities	124.1	117.4	86.3	66.3	46.3
Shareholders' Fund	430.3	417.3	478.6	518.3	570.4
Minority Interests	0.0	0.0	0.0	0.0	0.0
Equity & Liabilities	**734.5**	**749.5**	**826.5**	**888.2**	**942.7**

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