by Asia Analytica

3QFYDec2013 Results | **2 December 2013**

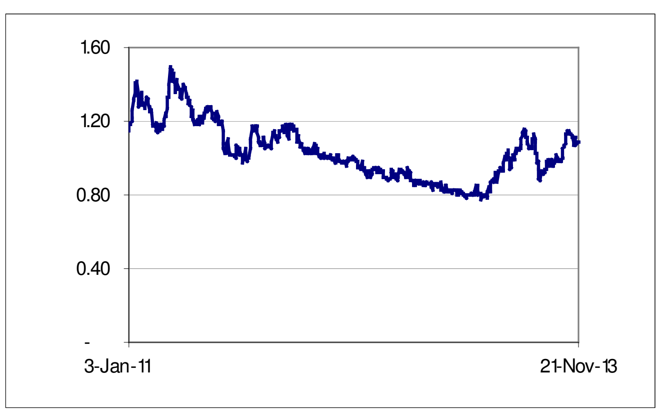
Malaysia Steel Works (KL) Bhd

- 3Q13 results just ahead of expectations
- Beneficiary of rising domestic construction activities
- Scrap costs more stable than iron ore
- Future earnings to be driven by volume sales

BUY

Key stock statistics	2012	2013E
EPS (sen)	11.0	13.6
P/E (x)	9.8	7.8
Net DPS (sen)	1.5	2.0
NTA/share (RM)	2.41	2.53
Issued capital (mil)	218	
52-week price range (RM)	0.77-1.19	
Major shareholders (%)		
Soon Seng Co.	38%	

Share Price Chart



Price
RM1.07

Market capitalization
RM237 million

Board
Main

Sector
Industrial Products

Stock code
5098

By
The Research Team

3QFYDec2013 Results Highlights:

Year end Dec (RM mil)	3Q13	3Q12	% chg
Turnover	351.2	312.9	12.2%
Operating profit	20.6	16.7	23.6%
Interest income/(exp)	(5.0)	(3.9)	29.1%
Extraordinary loss/(gain)	-	-	
Pre-tax profit	10.3	7.6	36.1%
Tax	0.6	0.5	10.5%
Net profit	9.7	7.0	37.9%
EPS (sen)	4.5	3.2	
Operating margin (%)	5.9	5.3	
Pre-tax margin (%)	2.9	2.4	
Net margin (%)	2.8	2.2	
Effective tax rate (%)	5.5	6.8	

Malaysia Steel Works (KL), Masteel's earnings results for 3QFYDec2013 were slightly ahead of our expectations. Nonetheless, we are keeping our earnings forecast intact, in view of the difficult operating conditions for the overall steel sector.

Masteel's turnover was up 12.2% y-y to RM351.2 million on the back of improved volume demand, which more than offset lower average selling prices for steel bars during this period.

Turnover in 3Q13 was also slightly higher from the previous corresponding quarter, by about 2.6%, despite slower construction activities during the Ramadan month and Hari Raya celebration.

The resulting improved plant utilization lifted operating margins for the company. Cost of scrap steel is also estimated to be about 5% lower from the previous corresponding period. As a result, the average cost of production was lower on-the-year in 3Q13.

The combination of higher sales and lower cost of production translated into better earnings for Masteel.

Pre-tax profit was up 36.1% y-y to RM10.3 million while net profit was up by 37.9% to RM9.7 million. This brings total net profit for the first nine months of the year to RM23.4 million, or about 10.6% higher from the previous corresponding period.

Outlook and Recommendation

Masteel's improved earnings in 3Q13 were in stark contrast to the other local steelmakers, all of which reported losses for the period.

We attribute this, in part, to the company's relatively smaller size and agility in managing its production and stock levels. Its electric arc furnace uses scrap steel as raw material. Scrap steel prices are generally less volatile compared to that for iron ore and coking coal, the main raw materials for larger blast furnaces. Case in point, iron ore prices rose by more than scrap steel prices in 3Q13 due to increased demand from Chinese steelmakers.

Masteel's plants are also well located in the Klang Valley, where a good portion of the country's construction activities is currently centered, including the multi-billion ringgit MRT project.

We believe that Masteel will continue to fare comparatively well going forward – although operating conditions will remain difficult.

Of primary concern is the persistent over-production in China, which has resulted in dumping activities in the region, including Malaysia. In the past year or two, the wire rod segment of the market – which Masteel is not involved in – was the most badly affected. Recently though there is anecdotal evidence that cheap steel bars are also being imported into the country – although this appears to be limited to specific property developments.

As we mentioned previously, most property/construction companies typically do not import and/or keep high inventory of steel bars, preferring to source their requirements on a timely basis from local steelmakers. They also have more stringent quality requirements.

Still, this issue is unlikely to go away anytime soon. At the very least, the threat of cheap imports will make it difficult for local steelmakers to raise prices – even though local demand is expected to stay quite robust. The Shanghai steel rebar futures are currently hovering around US$600 per metric tonne, equivalent to roughly RM1,940 before transportation costs, which are prevailing local prices.

Steel production in China kicked up to a high gear in the past few months. Based on October's output, the country is producing over 780 million metric tonnes of steel on an annualized basis – well in excess of its demand, estimated at up to 730 million metric tonnes this year, according to recent forecast by China Iron and Steel Association (CISA).

CISA forecasts output will hit 800 million metric tonnes in 2014, ahead of estimated demand of 760 million metric tonnes. This suggests the country will continue to export into the region. Indeed, industry observers estimated exports to have grown in the double-digits in the first ten months of this year.

China continues to struggle with over-capacity in its steel sector, despite attempts to close old steel plants. Currently, it is estimated to have total capacity of about 1 billion metric tonnes per annum.

On the domestic front, construction activities are estimated to grow by roughly 10% next year, underpinned by ongoing infrastructure and property projects. To be sure, the latter will be affected to a certain extent by recent government measures to tamp speculations in the sector, but demand is not expected to see a drastic drop.

Masteel is pushing ahead with its expansion plans. Construction of the company's new rolling mill is on track. The new plant will raise total capacity to about 550,000 metric tonnes from the current 350,000 metric tonnes.

Note that Masteel is currently outsourcing part of its milling operations due to in-house capacity limitations. Thus, once the new plant is operational, targeted by 2015, it can divert production back to its own mill.

The company also expects better margins from the new rolling mill, which will be adjacent to the meltshop in Klang, through savings from transportation and energy costs. The current rolling mill is located in Petaling Jaya.

To cater to the higher rolling mill volume, Masteel plans to increase its meltshop capacity to 700,000 metric tonnes from the current 600,000 metric tonnes through various production enhancement processes.

With these factors in mind, we expect Masteel to continue registering topline growth over the next few years – although margins may remain volatile, especially from quarter to quarter.

Operating costs is expected to rise going into 2014, the result of the government's subsidy rationalization plans. In addition to fuel price and its related price inflation, electricity and gas prices are widely expected to head higher next year. Recent reports suggest a quantum of between 10-20% increase for electricity tariffs. We estimate electricity and gas account for roughly 8% of total operating costs. Persistent weakness in the ringgit would also translate into higher import costs, including for scrap steel. It remains to be seen if steelmakers can fully pass on higher costs to consumers.

We are keeping our forecast unchanged, for now. Full-year earnings for 2013 are estimated at RM29.7 million – up 24% from RM23.9 million in 2012. The company has already earned RM23.4 million in 9M2013. Net profit is expected to improve to RM39.4 million in 2014 on the back of stronger volume.

We are keeping our **BUY** recommendation on the stock with a longer-term investment horizon but suspect upside gains will be capped in the near term.

For starters, sentiment for steel stocks is weak at the moment, dampened by the sea of red in 3Q13 for most of the local steelmakers.

Perwaja was recently designated PN17 status and is required to submit a regularization plan within the next 12 months. The company has also sought creditor protection and is expected to come up with a restructuring plan within the next few months.

Masteel's valuations are decent – with P/Es of about 7.8 and 5.9 times for 2013-2014, respectively. Indeed, the company is a comparatively safer bet for those looking for steel exposure. Plus, its shares are trading at only 0.42 times its book value of RM2.52.

The company has also pays consistent dividends, estimated to total 2 sen per share this year. This will give investors a net yield of 1.9% at the current share price.

In other developments, discussions for an intra-city commuter train project in Johor – under a 60:40 joint venture with KUB Malaysia – are still ongoing with the various government departments. We have not included any impact from the project in our earnings forecast.

Profit & Loss Analysis

Year end Dec (RM mil)	2011	2012	2013E	2014E
Turnover	1,253.4	1,312.2	1,381.3	1,450.3
Operating profit	66.9	61.8	69.1	87.0
Depreciation	21.3	21.8	21.7	24.1
Interest inc/(exp)	(16.5)	(15.5)	(16.1)	(19.2)
EI loss/(gain)	4.0	-	-	-
Pre-tax profit	25.1	24.4	31.2	43.7
Tax	0.5	0.6	1.6	4.4
Minority Interests	-	-	-	-
Net profit	24.5	23.9	29.7	39.4
EBITDA margin (%)	5.3	4.7	5.0	6.0
Pre-tax margin (%)	2.0	1.9	2.3	3.0
Net margin (%)	2.0	1.8	2.1	2.7
Effective tax rate (%)	2.2	2.3	5.0	10.0

Per Share Data

Year end Dec	2011	2012	2013E	2014E
EPS (sen)	11.6	11.0	13.6	18.1
P/E (x)	9.2	9.8	7.8	5.9
FD EPS (sen)	11.6	8.0	9.8	12.8
FD P/E (x)	9.2	13.4	10.9	8.4
Dividend (sen)	1.0	1.5	2.0	2.5
Net yield (%)	0.9	1.4	1.9	2.3
Payout ratio (%)	8.6	13.7	14.7	13.8
NTA/share (RM)	2.37	2.41	2.53	2.69
Price/NTA (x)	0.5	0.4	0.4	0.4
Cashflow/share (RM)	0.23	0.23	0.24	0.29
Price/cash (x)	4.6	4.6	4.5	3.7
Net gearing (%)	49.4	43.6	48.3	51.6
ROE (%)	5.0	4.7	5.5	6.9

Comments & contact: info@insiderasia.com *Tel: 03-77218060* *Fax: 03-77218061*

Asia Analytica Sdn Bhd *Suite 3B, Level 3, Menara KLK, 1 Jalan PJU7/6, Mutiara Damanasara, 47810 Petaling Jaya, Selangor, Malaysia*