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Masteel – Improved outlook but still challenging

Outlook for the steel sector has improved somewhat in recent months. Volume demand has picked up slightly while prices have also rebounded from the lows registered earlier in the year. Nevertheless, operating conditions remains challenging, at least for the next few months.

Whilst the worst is probably over, the pace of recovery is likely to be slow. We expect steel makers, including Malaysia Steel Works (Masteel; 95.5 sen), will continue to make losses in 2Q09 when their results are released over the course of the next few weeks – and may not return to profitability until the last quarter of the year or even 2010.

Positively, Masteel remains on firm financial ground and earnings should gradually improve in line with the global economic recovery.

Global outlook stabilising

Operating conditions are stabilising. World crude steel output declined by about 21.3% y-y during the first six month of the year, a slight improvement from the 22.8% fall in 1Q09. This number would have been far worse if not for China, where output growth was marginally positive. Production in the US and Europe dropped by as much as 40-50% over the same period.

Aggressive production cutbacks by the biggest steel millers have kept a tight rein on inventory as demand collapsed, so far. This helped buffer what could have been even sharper decline than the 45-50% fall in average steel prices from the peak in mid-2008.

Steel prices have started to inch higher since May, gaining by roughly 10-15%, so far, on the back stronger demand and higher than expected settlement price for the new iron ore contracts.

Nonetheless, it remains to be seen if the recent increases in sales are supported by real underlying demand or merely replenishment of inventory. Steel traders, in particular, are likely to have run down their inventories sharply during the worst of the credit and financial crisis and are now replenishing in anticipation of massive government stimulus project rollouts.

Excess production capacity, globally, is a big challenge. Market analysts estimate world crude steel output will only return to last year's record level in 2011, at the earliest. Current average utilisation rate for steel millers is estimated to be still below breakeven level. Hence, it would be tempting for them to step up production in response to higher demand – and potentially create an over supply situation. At the very least, the excess capacity would likely temper price gains in the near to medium term.

Masteel's utilisation level slowly rising

On the home front, industry demand too have improved a little, estimated at around 140,000 metric tonnes in June compared to 100,000-120,000 metric tonnes in the first five months of the year. Demand may, however, turn down again in August-September, ahead of the Hari Raya festive celebration.

Meanwhile, steel prices have rebounded off the lows in April-09 but are likely to remain, by and large, range bound due to the relatively slow pace of demand recovery. Case in point, prices for steel bars rose as high as RM2,200-RM2,300 per tonne last month but have since fallen back below RM2,000 per tonne.

Masteel should report lower losses in 2Q09 – compared to a net loss of RM30.4 million in 1Q09 – on the back of better plant utilisation and average selling prices. Current plant utilisation has improved to about 55% and 75% for billets and steel bars, respectively, from under 50% in the earlier part of the year. The company is exporting some of its steel bars, catering to niche markets where the margins are slightly better.

Earnings to gradually strengthen
Earnings are expected to strengthen gradually as the economic recovery gains traction. Masteel should return to the black in 2010.

Its balance sheet is in fairly good shape. The company has net debt of RM239 million at end-March 2009. The company's gearing, of about 60%, is below the industry average.

Masteel's share price remains well below its net tangible assets of RM2.05 per share as at end-March.

Year end Dec (RM mil)	2007	2008	2009E	2010E
Turnover	548.0	881.2	572.8	658.7
Pre-tax profit	45.7	85.7	(42.9)	24.2
Net profit	45.7	79.3	(42.9)	24.2
EPS (sen)	23.5	40.7	(22.0)	12.4
P/E (x)	4.1	2.3	nm	7.7
Dividend (sen)	2.3	2.5	0.5	1.0
Net yield (%)	2.4	2.6	0.5	1.0
NTA/share (RM)	1.83	2.21	1.99	2.10
Price/NTA (x)	0.5	0.4	0.5	0.5
Net gearing (%)	54.7	51.9	56.4	53.4