



Sector Update

Private Circulation Only

OVERWEIGHT

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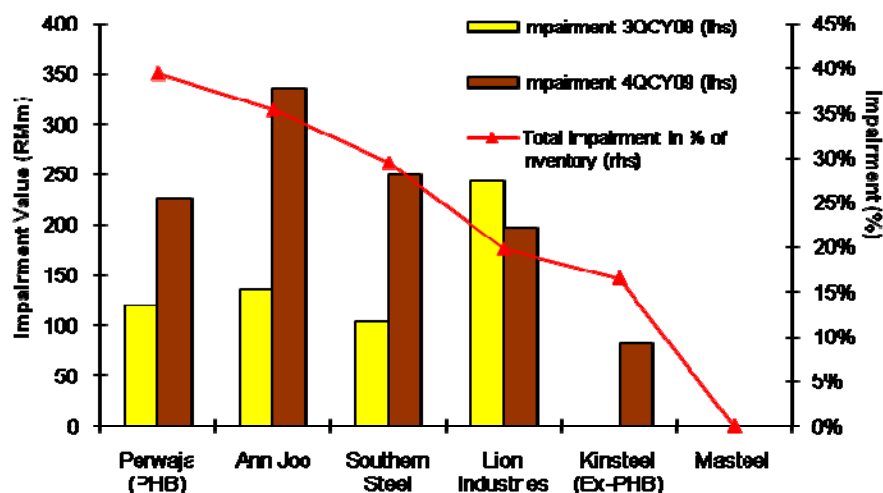
STEEL

Swimming Out Of The Red Ocean

2QCY09: On the edge of a sea of red ink. As most of the long steel companies have carried out aggressive kitchen sinking exercises in 2HCY08 (see Figure 1), more provisions for diminution in value of inventory may not be necessary for most of the local boys. Our estimates have also been proven right during the 1QCY09 results season as none of the local integrated long steel producers made further provisions although all millers were posting operating losses. Apart from that, average selling prices (ASP) made a comeback after dropping a notch after the Chinese New Year celebrations in February 2009 and strengthened further in May 2009. Although we suspect most, if not all, of the steel companies under our coverage were still mired in negative territory during the months of April and May 2009 after incorporating the 2-month regular lag of the higher ASP, we think that most may have returned to the black in June 2009. Therefore, any losses arising from lower ASPs will instead be realised as operational loss at a far lower quantum (see Figure 2).

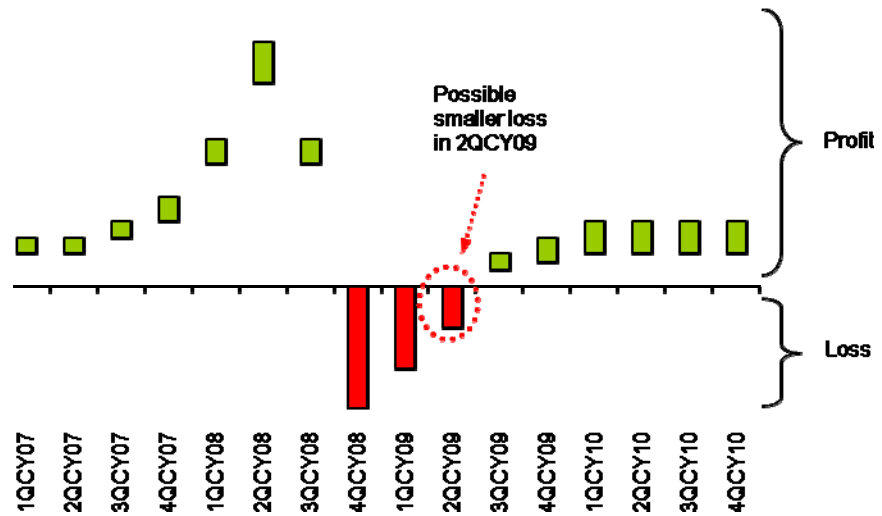
Returning to the black from 2HCY09. Post-spring cleaning in 1HCY09 together with the kitchen sinking in 2HCY08, we expect 2HCY09 to herald a new start for most or all of the steel millers. We expect the steel players to report a gradual improvement, with profit margins and demand picking up (see Figure 2). As steel prices have softened by some 5% from the recent peak, we do not expect another drastic drop in the near term although we would not totally rule out that possibility. The settlement of new iron ore benchmark prices for 2009/2010 marked a milestone for the steel industry as it gave steel prices a clearer direction in the year ahead. The market had been volatile when the rumour mill went on overdrive with regard to the quantum of drop in iron ore and coking coal prices. Moreover, the new contracts for iron ore and coking coal, which are 11% and 30% higher than the 2007/08 contract levels respectively, backs our view of this providing support to steel prices. The settlement certainly provided some degree of comfort to industry players in committing future orders.

Figure 1: Inventory Write-Downs in 2HCY08



Source: Company Data, OSK Research Estimates

Figure 2: Projection of Quarterly Earnings Trend



Source: OSK Research Estimates

Goodbye FY09, hello FY10. Based on the projected quarterly earnings trend, we remain hopeful of a better FY10 as various governments pour in money via their respective stimulus packages. We have been positive as these are highly likely to involve huge allocations for infrastructure, which may in turn boost steel demand. While FY09 will most certainly be a washout year for most local steel millers, we think the market has shifted its focus to FY10. Apart from that, a strong turnaround on quarterly basis may also draw the attention of investors who are on the lookout for “recovery play”.

No tariff hike gives relief. The media had been speculating on the possibility of higher electricity and natural gas tariffs. With the Cabinet deciding to not increase gas prices until Jan 1, '10, this is good news for local steel mills. Nonetheless, as the revision only provides temporary relief, we still expect a small quantum of increase in 2010. Therefore, for illustration purposes, every 1% increase in power tariff will translate into an additional cost of only US\$0.50 per tonne of integrated long steel production. However, Perwaja is the only company in our universe that consumes large amounts of natural gas in Peninsular Malaysia for its direct reduced iron (DRI), thus every 1% increase may add approximately US\$0.45 in extra cost per tonne of DRI. With that, so long as the quantum of adjustment is small, it may have limited impact as the present spread between the cash cost and selling price return to healthy levels.

INVESTMENT RECOMMENDATION – INCORPORATE LIQUIDITY PREMIUM

Liquidity trump card in play. Valuation is an art, but it can over- or under-shoot according to market movements. Considering that the market is currently flush with liquidity, investors are now more willing to bear higher risks. Thus the market may switch its attention on high beta stocks including steel counters in the short term. We had highlighted in our previous sector update dated May 15, '09 (Show Your Trump Card Now) on the possibility of valuation expansion, such as in the form of higher PER, or move a stock on NTA per share basis (refer to Figure 3). However, as we had insisted that such an upgrade should require more solid justification, we had misread the situation as strong liquidity in the market has whetted the market’s appetite for risk. The stocks under our SELL list continue to trade above our target prices despite the fact that their valuations were much expensive than their peers and they possess fundamentals that may not justify such price levels.

Figure 3: Potential Valuation Expansion

FY10 NTA		?	PER							
FY10 EPS		?	3	4	5	6	7	8	9	10
P/NTA	1 STD	?								
	Mean	?								
	-1 STD	?								

Source: OSK Research Estimates

Time to throw in a liquidity premium? In admitting our oversight, we had decided to take a re-look at the valuation parameter of every long steel counter under our universe. We also formulate our hypothesis, which is set out in the table below, to arrive at our new fair values:-

1. Ann Joo (NEUTRAL; RM2.02)

The company's share price has continued to stay above our fair value despite our last downgrade to SELL. However, in recognition of the market's higher risk appetite, we recently upgraded the stock to NEUTRAL but maintain our fair value at RM1.25. Considering that Ann Joo's share price has stayed firmly above the RM2.00 level, we have decided to upgrade our target price to RM2.02 based on 8x FY10 EPS and 1.27x NTA per share, or +1 standard deviation of historical trading range, but retain our NEUTRAL call as a re-rating is possible only with real improvement in fundamentals.

Figure 4: Valuation Matrix of Ann Joo

FY10 NTA		\$1.86	PER							
FY10 EPS		\$0.21	3	4	5	6	7	8	9	10
P/NTA	1 STD	1.27	\$1.50	\$1.60	\$1.71	\$1.81	\$1.92	\$2.02	\$2.13	\$2.24
	Mean	0.78	\$1.04	\$1.14	\$1.25	\$1.36	\$1.46	\$1.57	\$1.67	\$1.78
	-1 STD	0.28	\$0.58	\$0.69	\$0.79	\$0.90	\$1.00	\$1.11	\$1.21	\$1.32

Source: OSK Research Estimates

2. Kinsteel (NEUTRAL; RM0.91)

Kinsteel's share price is also trading firmly above our target price despite our last downgrade to SELL. As the scenario is the same as that for Ann Joo, we have decided to apply a similar valuation parameter on the company. Based on 8x FY10 EPS and 1.25x NTA per share, or +1 standard deviation of historical trading range, we derive a higher fair value of RM0.91 from RM0.59 previously for Kinsteel and are thus upgrading our call from SELL to NEUTRAL.

Figure 5: Valuation Matrix of Kinsteel

FY10 NTA		\$0.92	PER							
FY10 EPS		\$0.08	3	4	5	6	7	8	9	10
P/NTA	1 STD	1.25	\$0.70	\$0.74	\$0.79	\$0.83	\$0.87	\$0.91	\$0.95	\$1.00
	Mean	0.82	\$0.50	\$0.54	\$0.59	\$0.63	\$0.67	\$0.71	\$0.75	\$0.80
	-1 STD	0.39	\$0.31	\$0.35	\$0.39	\$0.43	\$0.47	\$0.51	\$0.56	\$0.60

Source: OSK Research Estimates

3. Lion Industries (BUY; RM2.11)

Lion Industries continues to top our BUY list. Although the company's share price has gained more than three-fold from its year low, it has continued to trade at a huge discount to its peers despite being the country's largest integrated long steel player. As the stock's last traded price stills offer a decent upside from our original fair value of RM2.05, we are moving our valuation parameter up a notch from 5x to 6x FY10 EPS but retain our 0.43x FY10 NTA per share valuation, which is derived from the mean of its historical trading band. Our target price is upgraded to RM2.11 and our BUY call maintained.

Figure 6: Valuation Matrix of Lion Industries

FY10 NTA		\$4.08	PER							
FY10 EPS		\$0.41	3	4	5	6	7	8	9	10
P/NTA	1 STD	0.63	\$1.90	\$2.10	\$2.30	\$2.51	\$2.71	\$2.91	\$3.12	\$3.32
	Mean	0.43	\$1.50	\$1.70	\$1.90	\$2.11	\$2.31	\$2.51	\$2.72	\$2.92
	-1 STD	0.25	\$1.12	\$1.32	\$1.53	\$1.73	\$1.94	\$2.14	\$2.34	\$2.55

Source: OSK Research Estimates

4. Malaysia Steel Works (KL) (Masteel) (BUY; RM1.20)

We are impressed with management's quick reaction in liquidating its stockpile when steel prices started to fall, which helped Masteel to avoid a huge write-down in 2HCY08. While our original target price of RM1.09 still offers some decent upside, we are moving our valuation parameter up a notch from 5x to 6x FY10 EPS but retain our 0.46x FY10 NTA per share valuation, derived from the mean of its historical trading band. Our fair value is thus upgraded to RM1.20 and our BUY recommendation maintain.

Figure 7: Valuation Matrix of Masteel

FY10 NTA		\$2.45	PER							
FY10 EPS		\$0.21	3	4	5	6	7	8	9	10
P/NTA	1 STD	0.61	\$1.07	\$1.17	\$1.28	\$1.38	\$1.49	\$1.60	\$1.70	\$1.81
	Mean	0.46	\$0.88	\$0.99	\$1.09	\$1.20	\$1.30	\$1.41	\$1.52	\$1.62
	-1 STD	0.32	\$0.71	\$0.82	\$0.92	\$1.03	\$1.13	\$1.24	\$1.35	\$1.45

Source: OSK Research Estimates

5. Perwaja (TRADING BUY; RM1.78)

With the news of a 48.3% price cut in iron ore pellets and the deferment of a price hike on natural gas price hike, we think the company is a good trading candidate. Although it lacks a trading record on its relatively short listing history, we continue to value the company on a PER basis but are lifting our parameter from 5x to 8x FY10 EPS. Our target is upgraded from RM1.67 to RM1.78 and our Trading BUY call remains unchanged.

Figure 8: Valuation Matrix of Perwaja

FY10 NTA		\$2.45	PER							
FY10 EPS		\$0.21	3	4	5	6	7	8	9	10
FY10 EPS		0.22	\$0.67	\$0.89	\$1.11	\$1.33	\$1.56	\$1.78	\$2.00	\$2.22

Source: OSK Research Estimates

6. Southern Steel (BUY; RM2.12)

Southern Steel is among our steel sector favourites for its dedicated management team, which managed to turn the company around from the 1997 Asian Financial Crisis. As the company's share price had recently exceeded our original fair value of RM1.93 for a short period of time, we think it is time to lift our valuation parameter up a little. We reiterate our BUY recommendation with new target price of RM2.12, derived from an upgrade of 5x to 6x FY10 EPS and retain 0.91x FY10 NTA per share, or the mean of its historical trading band.

Figure 9: Valuation Matrix of Southern Steel

FY10 NTA		\$2.13	PER							
FY10 EPS		\$0.38	3	4	5	6	7	8	9	10
P/NTA	1 STD	1.17	\$1.82	\$2.02	\$2.21	\$2.40	\$2.59	\$2.79	\$2.98	\$3.17
	Mean	0.91	\$1.55	\$1.74	\$1.93	\$2.12	\$2.32	\$2.51	\$2.70	\$2.89
	-1 STD	0.66	\$1.28	\$1.47	\$1.67	\$1.86	\$2.05	\$2.24	\$2.43	\$2.63

Source: OSK Research Estimates

In short, we are putting a higher premium on stocks that are more institutionalised. We have upgraded our valuation parameter for Ann Joo and Kinsteel from 5x to 8x FY10 EPS and lifted our valuation of P/NTA to +1 from the mean standard deviation of their historical trading band. Perwaja's valuation is also lifted purely from 5x to 8x FY10 EPS considering management's efforts in fostering investor relations. However, we only revise our valuation up a notch for Lion Industries from 5x to 6x FY10 EPS and retain our mean of its historical trading band of P/NTA, after taking into consideration its relatively complicated cross holding structure that may cause investors to shy away. We also apply a valuation parameter similar to Lion's for Masteel and Southern Steel after incorporating their relatively weaker liquidity.

Trump card for re-rating. As positive market sentiment and market liquidity has kept whetted investors' risk appetite, we will continue to monitor the developments that may trigger our re-rating, such as:-

- Swing of news flow on significant infra or other construction projects being awarded locally and abroad; i.e. the combined projects launched by local governments must at least carry an indicative annual spending exceeding RM15bn.
- Steel price continues to strengthen with support from a strong recovery in the global economy, i.e. EBITDA margin for steel bar and wire rods to expand above US\$50 per tonne.
- Firmer steel demand in the physical market that is more sustainable.
- Another shortage of steel billets in SEA, Middle East, etc., or
- Any other developments that may spur interest on steel counters.

Reiterate OVERWEIGHT. We think global steel demand, including that for the domestic market, is on the track of gradual recovery from the anaemic levels of 4QCY08. We have high expectation of the rollout of projects under various stimulus packages that may spur steel millers' bottom-lines, especially in the upcoming year (CY10). Local steel mills may continue to export billets within the South-East Asia (SEA) market as China creates a vacuum after the imposition of 25% export tax. The Middle East, Australia, Pakistan, Bangladesh and so on will also be a boon to Malaysia's billet exports if these economies improve. With that, we maintain our OVERWEIGHT stance on the steel sector with focus on the long players. We advise investors to focus on the steel counters that still offer a decent valuation despite after the sharp run-up in their share prices over the past few months. Top in our BUY list is Lion Industries with fair value of RM2.11, while other BUYs are Southern Steel and Masteel, with 12-month target prices of RM2.12 and RM1.20 respectively. We maintain our Trading BUY for Perwaja with a fair value of RM1.78. Despite upgrading our valuation parameter to 8x FY10 EPS and +1 standard deviation of historical trading range, Ann Joo's and Kinsteel's fair value of RM2.02 and RM0.91 respectively only justify our NEUTRAL recommendation.

RECOMMENDATIONS

Company	Current Price	Fair Value	Call	EPS		PE (x)		P/NTA	DY	Mkt. Cap (RMm)
				FY1	FY2	FY1	FY2	FY1	FY2	
Ann Joo Resources	2.230	2.02	NEUTRAL	4.7	21.1	47.3	10.5	1.3	0.9	1165.6
Kinsteel	0.965	0.91	NEUTRAL	n.m	8.4	-59.0	11.5	1.1	0.0	894.6
Lion Industries	1.480	2.11	BUY	n.m	40.8	-4.1	3.6	0.4	0.0	1055.1
Malaysia Steel Works	0.950	1.20	BUY	6.0	21.2	15.9	4.5	0.4	0.8	184.9
Perwaja Holdings	1.550	1.78	T. BUY	n.m	22.2	-20.8	7.0	0.9	0.0	868.0
Southern Steel	1.740	2.12	BUY	11.6	38.5	15.1	4.5	1.0	1.6	729.8
Average				n.m	25.4	-0.9	6.9	0.9	0.5	816.3

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