InsiderAsia
by Asia Analytica

Company Update

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Malaysia Steel Works (KL) Bhd

- Benefit from rising construction activities
- Steel bar prices supported by domestic demand
- Lower and more stable raw material costs
- Earnings to be driven by volume sales

BUY

Price
RM1.04

Market capitalization
RM227 million

Board
Main

Sector
Industrial Products

Stock code
5098

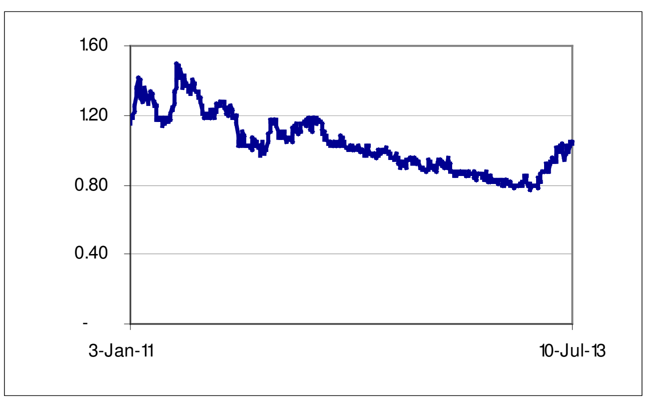
By
The Research Team

Key stock statistics	**2012**	**2013E**
EPS (sen)	11.0	13.6
P/E (x)	9.5	7.6
Net DPS (sen)	1.5	2.0
NTA/share (RM)	2.41	2.53
Issued capital (mil)	218	
52-week price range (RM)	0.77-1.10	

Major shareholders (%)

Soon Seng Co.	38%

Share Price Chart



Recent Developments

We are fairly upbeat on the prospects for Malaysia Steel Works (KL) (Masteel) going forward.

To be sure, the domestic steel sector has had its ups and downs over the last few years. Bursa-listed steel companies such as Perwaja and its parent company, Kinsteel were loss-making from 2010-2012 while Ann Joo Resources slipped into the red last year following a sharp net profit decline in 2011. The volatile performance was due to a confluence of factors including fluctuating prices for raw materials as well as weak export demand and selling prices for steel products. Outlook for the global steel industry remains challenging.

On a positive note, Masteel has fared pretty well by comparison. It managed to stay profitable in the past three years – making some RM26 million in profit annually, on average, after recovering from a net loss of RM8.5 million in 2009, in the immediate aftermath of the global financial crisis. The company reported net profit of RM3.6 million in its latest 1Q13 earnings results.

The comparatively better performance could be attributed, in part, to Masteel's smaller scale operations and nimble inventory management. Its gearing level is also among the lowest in the sector, at 47% at end-1Q13 – net debt totaling RM247 million, the bulk of which is for trade-related working capital and the company's expansion plans. The relatively low gearing bodes well for the company's comparative production costs going forward – when interest rate starts to trend higher.

Additionally, its meltshop and rolling mill are located in Klang and Petaling Jaya, respectively, and are thus, well positioned to capture growing demand within the greater Klang Valley – where many construction projects are ongoing. These include the KVMRT 1, LRT extension, LCCT Terminal as well as private and public property projects such as affordable housing projects under PR1MA. Lower transportation costs gives the company an edge in pricing its steel bars.

All the above-mentioned factors, we believe, will remain in the company's favour going forward.

Construction activities picking up steam

Domestic demand for steel bars is expected to remain quite robust, underpinned by forecasts for stronger construction sector – infrastructure and property – growth over the next few years.

Momentum for the rollout of projects under the Economic Transformation Programme is picking up speed again, with the conclusion of the general election in May. For instance, the government is already talking about the next two phases for the MRT project. Construction works on the first phase are progressing on track. There are also discussions on the possibility of implementing a high-speed rail (HSR) link connecting Singapore and Kuala Lumpur.

Property projects in select locations such as Iskandar Malaysia are still in demand despite recent Bank Negara curbs on the sector.

Local construction activities will keep the industry utilisation rate for steel bars around 70-80% – enabling companies to benefit from economies of scale.

Having said that, steel bar prices could still see some downside risks in the coming months affected by persistent weakness in the global market.

Global steel prices look likely to stay soft

Softness in global steel prices will likely cap any attempts to raise domestic selling prices even as volume demand improves. In fact, the risk for steel bar prices at this point is to the downside, but likely moderately so.

Case in point, local prices for steel bars were relatively resilient through 2012 and 1H13 – hovering within a narrow range and averaging around RM2,200 per tonne – despite falling global steel prices.

Much of the persistent weakness in the global market is down to continued overproduction in China, which accounts for almost half of the world's total output. The country's annualised crude steel production in March-May 2013 is running close to 800 million tonnes – nearly 20% above the World Steel Association's estimate for apparent steel use in the world's second largest economy this year. Demand has been sluggish as its economy slows at a faster than expected rate. China is in the midst of transitioning from an investment and export-centric economy to one that is more domestic consumption driven.

Market observers are not optimistic on the industry cutting back on production, due to myriad reasons such as fears over losing existing bank credit and market share. Also, many steel mills are state-owned, which makes retrenchment and/or plant closure difficult.

The average spot price for rebar in China is now hovering around the equivalent of about RM1,775 per tonne. On a slightly more positive note, continued urbanization and redevelopment of shantytowns are likely to hold up demand, to a certain degree. The Shanghai steel bar futures have rebounded somewhat, to around RM1,880 per tonne currently, after prices fell to 9-month low levels last month.

Local steel bars segment holding up well

Rising domestic demand had kept local prices for steel bars resilient, so far, despite weak outlook for the global steel industry.

Fortunately, this segment of the market had emerged relatively unscathed from the dumping activities that negatively affected prices and margins for some steel products, noticeably for wire rods.

Imports of steel bars are still low relative to total consumption in the country, at roughly 6.5% in 2012. By comparison, imported wire rods accounted for almost 40% of total domestic consumption last year.

This will likely remain the case going forward given the steel bar's industry dynamics – 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 manufacturers – and more stringent quality requirements.

Stable raw material costs to help margins

Whilst there is moderate downside risk to steel bar prices in the near term, this will likely to be matched by lower and more stable raw material prices – thereby preserving margins for steelmakers. One of the reasons for steel company losses in 2011-2012 was inventory write-down.

Prevailing market consensus suggests prices for the key steel-making raw materials, iron ore and coking coal, will be range bound for the foreseeable future. On the one hand, rising cost of production will limit downside price pressure. On the other, increasing supply from new projects, the result of heavy investments made during the recent commodity price boom, coming onstream will temper price rallies.

Iron ore is now trading around US$120 per tonne – below the year-to-date average of about US$140 per tonne and high of nearly US$160 per tonne in February 2013. Meanwhile, coking coal is selling for about US$140 per tonne, compared with the average of about US$210 per tonne in 2012 and record high of US$330 per tonne in 2Q11.

Earnings Outlook

As mentioned above, Masteel's sales having recovered from the global financial crisis have been expanding steadily – rising from RM687 million in 2009 to RM1.31 billion last year. That is equivalent to a compounded growth (cagr) of over 24% per annum.

We expect sales to remain in an uptrend over the next few years, supported by improving local demand. Masteel has also been busy cultivating longer-term export markets.

For example, it secured an off take contract with Trafigura, one of the world's largest traders in bulk and non-ferrous minerals, in June 2012. Under the 3-year agreement worth some RM500 million, which could be a prelude to a longer-term relationship, Masteel will supply billets and steel bars to the latter's regional clients.

With sales expected to trend higher, margins too are likely to improve on the back of economies of scale and lower costs for raw materials.

Scrap steel – the primary raw material for Masteel's arc furnace – is now selling for roughly US$340 per tonne, compared with US$440-450 per tonne in 1H12. By comparison, domestic steel bar prices have fallen by a lesser quantum – from about RM2,200-2,300 per tonne in 1H12 to the current RM2,100-2,200 per tonne.

Thus, we expect the company's earnings to strengthen over the coming quarters, improving from the RM3.6 million reported for 1Q13.

Expanding capacity to cater to rising demand
Masteel is sufficiently upbeat on outlook for the industry to embark on the next expansionary phase – with both its meltshop and rolling mill currently running at about 85% capacity.

To cater to future demand growth, the company has started construction works on a new RM100 million rolling mill, adjacent to the existing billet plant. Upon completion – targeted by end-2014 – the company's total milling capacity will be boosted to 550,000 tonnes, up some 57% from the current 350,000 tonnes.

Meanwhile, it has already spent some RM80 million to upgrade the billet plant, pushing capacity from the original 450,000 tonnes to 600,000 tonnes at end-2012. This will be further raised to 650,000 tonnes and 700,000 tonnes by end-2013 and end-2014, respectively.

Currently, Masteel exports the excess billets. Once the new rolling mill is up and running, by 2015, much of the billets will be re-directed as feedstock for the production of steel bars – thus, enabling it to optimize value from both operations. Production at the new mill is also expected to be more efficient given its location right next to the meltshop.

On a separate note, the company is still in discussions to build and operate an intra-city commuter rail network in Johor, under a joint venture with KUB Malaysia. The proposed concession agreement will include the building of 20 new stations and the suggested route – using existing KTMB rail tracks – would cover all five flagship zones in Iskandar Malaysia. The project is estimated to cost about RM1 billion. We have not included any contribution from the proposed rail project in our earnings forecast.

Valuations and Recommendation

Masteel is among the cheapest steel stocks in terms of price-to-net assets valuation. Its shares are being priced well below its book value of RM2.43 – at only 0.43 times.

Based on our net profit forecast of RM29.7 million and RM39.4 million for 2013-2014, the stock is trading at P/E multiples of only 7.6 and 5.8 times, respectively.

Looking further ahead, we expect sales growth to gain further momentum in 2015, supported by contributions from the new rolling mill. This should drive valuations even lower. Thus, we are keeping our **BUY** recommendation.

Masteel has a good track record of rewarding shareholders with dividends, even maintaining payments through the global financial crisis, albeit at a reduced sum. In line with the improved outlook, the company raised dividend per share last year – to 1.5 sen from 1 sen in 2011.

There are also indications the company will increase the frequency of payments, to at least twice a year. We assumed dividend payout would average around 15% of net profit going forward.

Based on our estimates of 2 and 2.5 sen per share dividends for 2013-2014, respectively, shareholders will earn net yields of 1.9-2.4% for the two years.

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)	8.9	9.5	7.6	5.8
FD EPS (sen)	11.6	8.0	9.8	12.8
FD P/E (x)	8.9	13.0	10.6	8.1
Dividend (sen)	1.0	1.5	2.0	2.5
Net yield (%)	1.0	1.4	1.9	2.4
Payout ratio (%)	8.6	13.7	14.7	13.8
NTA/share (RM)	2.37	2.41	2.53	2.68
Price/NTA (x)	0.4	0.4	0.4	0.4
Cashflow/share (RM)	0.23	0.23	0.24	0.29
Price/cash (x)	4.5	4.5	4.4	3.6
Net gearing (%)	49.4	43.6	48.3	51.7
ROE (%)	5.0	4.7	5.5	6.9

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