Masteel upbeat about growing demand

In our previous article, we discussed the improving outlook for the steel industry on the back of expectations for rising domestic demand for steel bars and lower raw material costs. Indeed, all of the steel companies listed on Bursa Malaysia reported better quarter-on-quarter (q-o-q) earnings results for the first quarter (1Q) of 2013, although some remained in the red.

Local demand for steel bars is expected to remain robust, underpinned by stronger construction sector — infrastructure and property — growth forecast for the next few years. Malaysia Steel Works (KL) Bhd (Masteel) is sanguine that it will benefit from this strengthening demand, supported by a competitive cost structure and the location of its plants.

For starters, the company has one of the lowest gearings among steel companies, second only to Lion Industries Corp Bhd. (Note that Lion has a diversified earnings base and derives a significant portion of its earnings from retail associate company Parkson Holdings Bhd.) Masteel's gearing stood at 47% as at end-1Q13, with net debt totalling 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 its comparative production costs when interest rates start to trend higher.

The company is nimble in its inventory management, remaining profitable through the volatile operating environment of the past three years. Furthermore, Masteel's meltshop is located in Klang and its rolling mill in Petaling Jaya, Selangor, so the company is well positioned to capture growing demand within the Klang Valley, where many construction projects are ongoing such as the Klang Valley mass rapid transit system 1, light rail transit system extension, the low-cost carrier terminal as well as private and public property projects such as affordable housing projects under PR1MA. Lower transport costs give the company an edge in pricing its steel bars.

Masteel's sales have recovered from the global financial crisis and have been expanding steadily, rising from RM687 million in 2009 to RM1.31 billion last year. That is equivalent to a compound annual growth rate of over 24% per year.

We expect sales to remain in an uptrend over the next few years, supported by local demand, exports and its expansion plans.

Expanding capacity to cater for rising demand

Aside from capitalising on strengthening local demand, Masteel is cultivating longer term export markets. For example, it secured an offtake contract with Trafigura Beheer BV, one of the world's largest traders in bulk and non-ferrous minerals, in June 2012. Under the three-year agreement worth some RM500 million, which could be a prelude to a longer-term relationship, Masteel will supply billets and steel bars to Trafigura's regional clients.

Both its meltshop and rolling mill are currently running at about 85% capacity. To cater for expected demand growth, Masteel has started construction 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.

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

Nimble enough to stay profitable in the past three years

As mentioned in our previous article, selling prices for steel bars are likely to stay fairly resilient supported by domestic demand. Prices hovered within a narrow range and averaged around RM2,200 per tonne through 2012 and the first half (1H) of 2013 despite a weakening outlook for the global steel industry.

This segment of the market emerged relatively unscathed from the dumping that negatively affected prices and margins for some steel products, noticeably wire rods. This could be attributed in part to more stringent quality requirements. Also, construction companies typically do not import and/or keep high inventories of steel bars, preferring to source their requirements on a timely basis from local manufacturers.

There is moderate downside risk to steel bar prices in the near term. But this is likely to be matched by falling raw material prices. Scrap steel, the primary raw material for Masteel's arc furnace, is now selling for roughly US$340 (RM1,003) per tonne, compared with US$440 to US$450 per tonne in 1H12. Steel bar prices have fallen by a smaller quantum, from about RM2,200 to RM2,300 per tonne in 1H12 to the current RM2,100 to RM2,200.

As such, we believe margins and earnings will strengthen through the remainder of the year. Masteel reported net profit of RM3.6 million in 1Q 2013 financial year ending December (FY13), from a net loss of RM4.9 million in the previous corresponding quarter.

Attractive valuations for cyclical upturn

Masteel is among the cheapest steel stocks in terms of price-to-net asset valuation. The stock is trading below its book value of RM2.43. The company also maintained dividend payments throughout the global financial crisis, albeit at a reduced sum. We believe dividend payout will average around 15% of net profit going forward. There are also indications the company will increase the frequency of payments, to at least twice a year. Dividend yield is estimated at 2% to 2.5% for FY13/FY14.

Based on our net profit forecast of RM29.7 million for FY13 and RM39.4 million for FY14, its shares are trading at a price-earnings ratio of only 7.3 for FY13 and 5.5 times for FY14. Looking further ahead, we expect sales growth to gain momentum in 2015, when the new rolling mill is commissioned. This should drive valuations even lower.

Note: This report is brought to you by Asia Analytica Sdn Bhd, a licensed investment adviser. Please exercise your own judgment or seek professional advice for your specific investment needs. We are not responsible for your investment decisions. Our shareholders, directors and employees may have positions in any of the stocks mentioned.