Insider Asia: Masteel: Volume demand to drive growth

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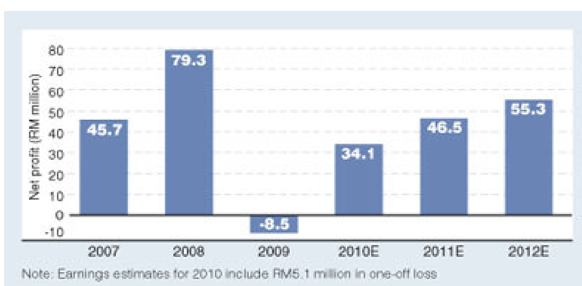
Outlook for the steel industry is improving on the back of the expected increased spending for infrastructure and development projects recently announced under the various government initiatives.

In addition to some RM49.2 billion allocated for development expenditure under the Budget 2011 — for hospitals, schools, infrastructure, etc — some RM12.5 billion of the 52 high impact projects under the Private-Private Partnership (PPP) initiative are to be implemented in 2011. The latter includes several highways, oil & gas facilities, a power plant and an eco-nature resort.

Furthermore, the government has unveiled several large-scale projects that will be completed over the next few years. Topping this list is the RM40 billion mass rail transit (MRT) system for Klang Valley, which could kick off as early as next year.

There are also two other development huge projects on the drawing board — the RM10 billion Sg Buloh mixed development and RM5 billion Warisan Merdeka, which will undertaken by the EPF and PNB, respectively.

Thus, we expect volume demand for building materials such as steel to register fairly good growth for the foreseeable future.



Higher utilisation rates at Masteel's plants

Utilisation rates at Malaysia Steel Works' (RM1.04) meltshop and rolling mill have been trending higher. Currently, the billets plant is running at about 75% of capacity, up from about 60% in July while utilisation at the rolling mill has risen to roughly 85%.

In fact, the company is finalising plans for an additional mill to keep up with the expected demand going into the next year. If all goes to plan, Masteel intends to commission an additional 150,000 tonnes in rolling mill capacity, or about 43% increase from its existing production capacity, by 2012.

It is also exploring the viability of a bigger plant to expand its product range.

This project, if it goes ahead, is likely to cost about RM300 million — and will probably entail some fund raising from the capital market.

Shareholders gained from 1-for-2 warrants rights issue

Masteel raised about RM35.4 million this year from a private placement of 16.1 million shares and rights issue of warrants to shareholders on the basis of one warrant for every two shares held.

The rights issue exercise, which was completed recently, has given shareholders fairly good returns. Priced at 18 sen per warrant, it is now trading at 43 sen. The exercise price was fixed at 67 sen with a five-year maturity period.

Selling prices for steel may stay flattish but well supported Although domestic demand for steel is expected to grow, selling prices could remain flattish in the foreseeable future, weighed down, in part, by sluggish global prices.

The big steelmakers have been issuing cautious guidance in terms of outlook for the next one to two quarters.

Global demand growth is expected to drop with the end of crisis-induced stimulus programmes and inventory rebuilding while government austerity plans in Europe and policy tightening in China will start to bite.

The World Steel Association estimates global demand growth will moderate to 5.3% in

2011, from the growth forecast of 13.1% this year. Indeed, steelmakers are already finding it difficult to make recent price hikes stick.

Still, with signs that prices for raw materials like iron ore and metallurgical coal are trending higher anew, rising costs should provide fairly good support to end-product prices.

For example, spot prices for iron ore have recovered to around US$150 (RM463.50) per tonne currently compared with the quarterly contract price of about US$125-US$130 per tonne for 4Q10 (which was based on average prices in 3Q10). Thus, it is unlikely that prices for steel products would fall sharply even if demand cannot absorb higher prices.

Domestic selling prices for steel bars are currently hovering around RM2,000 per tonne and could stay range bound in the near to medium term. The stronger ringgit makes for cheaper imports, which would temper any attempts to raise prices.

Local steel millers are in discussion with the government on various proposals to help buffer against rising feedstock costs.

This includes the possibility of reinstatement of the 5% import duty on steel bars, higher duty on the export of iron ore and scrap as well as the allocation of economic-sized land for mining activities. Earnings outlook to gradually improve

On balance, we expect Masteel's earnings will continue to strengthen in the coming quarters. The upcoming 3Q10 results will be impacted by some RM5 million in one-off losses related to its biotech venture. But underlying operating profit is expected to show improvement from the preceding quarters.

We estimate net profit at roughly RM34 million this year and improving to RM46.5 million in 2011. That implies its stock is trading at fairly modest P/Es of just about 6.4 and .7 times our estimated earnings.

Thus, we are sanguine that the stock would appreciate further on the cyclical upturn for the sector. Its shares are also priced well below net tangible assets of RM2.12 per share as at end-June 2010.

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