Analyse This...

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Malaysia Steel Works (KL) Bhd

Iron-clad prospects

MSW MK
NOT RATED

Price @8/4/11: RM1.40
52-week range (MYR): 0.82 – 1.48
Market cap – RM295m

Deep-value steel stock

- Malaysia Steel Works (Masteel) is on an expansion programme that is set to double its earnings to RM80m-90m by FY12, lowering its FD P/E to below 5x or 60% below the KLCI P/E. We believe the target is achievable as it is expanding capacity to meet rising demand from property launches and ETP infrastructure project starts. On P/NTA basis, the stock is cheap at 0.6x CY10, 40% below the sector. We value Masteel at 10.2x forward P/E, 30% below our 14.5x target market P/E. This works out to RM2.95, more than double its current price. Masteel's valuation discount is wider than Ann Joo's 10%. Should it succeed in its bid for the Iskandar rail project, FY12 FD core EPS rises by 29% to 37.4 sen, implying a value of RM3.80 or hefty upside of 170%.

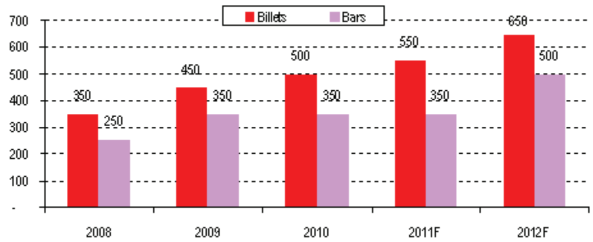
Background

- This manufacturer of high-tensile steel bars and billets started in 1971 with a rolling mill that could produce 30k metric tonnes of steel bars annually. Today, its facilities in Section 51 of Petaling Jaya and Bukit Raja, Klang house a 500k metric tonne p.a. billet plant and a rolling mill with an annual capacity of 350k metric tonnes of steel bars. In comparison, Ann Joo (AJR MK; Outperform) has a billet capacity of 680k metric tonnes p.a. and three rolling mills with an annual capacity of 580k metric tonnes. Steel bars contribute 60% of Masteel's revenue while sales of semi-finished steel billets make up the remaining 40%. By virtue of its central location in the Klang Valley, Masteel has good exposure to the country's property boom, selling 70% of its products to property developers and the balance to construction companies. It distributes its products in Malaysia through more than 65 dealers and exports 30-40% of its products through trading partners in Australia, New Zealand, Indonesia, Singapore, Thailand, Vietnam and the Philippines. Dato' Ikhwan Salim bin Dato' Haji Sujak has served as Masteel's chairman since 2003 and is also the division head of Umno's Petaling Jaya Utara division. Masteel's major shareholders are the company's CEO and Executive Director Dato' Sri Tai Hean Leng (34%), Lembaga Tabung Haji (7%), and Dato' Ikhwan (4%).

Outlook

- **Capacity expansion.** Masteel is expanding capacity at its steelmaking plants and rolling mills as management foresees higher demand from recent property launches and the federal government's Economic Transformation Programme (ETP) infrastructure projects. By 2012, we expect Masteel to have a billet capacity of 650k metric tonnes p.a. and a rolling mill with an annual capacity of 500k metric tonnes of steel bars.
- **Superior location.** Masteel is one of two steel companies in the Klang Valley, the other being the Lion group's Amsteel. Its central location gives it a cost advantage over its competitors as transportation costs are RM20-22 per metric tonne or 50% lower than its rivals' RM40-50 per metric tonne cost. We believe this will enable the company to benefit from ETP spending on projects such as the MRT and LRT extensions. Masteel's central location also means that it is a key beneficiary of the Klang Valley's property boom with 70% of revenues coming from blue-chip property developers such as the Sunrise group.

Masteel's capacity ('000 metric tonnes)



Source: Masteel investor presentation

- **Close to property developers.** Management has good relationships with several developers and has even signed long-term contracts for steel bars with some. While most sales are through distributors, Masteel's close relationships have enabled the company to sell directly to developers in the Klang Valley. We believe that Masteel's high exposure to the property sector will help underpin its FY11-12 earnings growth.
- **Bullish on property, construction.** Steel stocks were re-rated on Friday, with share prices rising 5.7% on average, outpacing the FBM KLCI's 0.3% decline. Our sense from speaking with steel players is that steel demand is set to rise in 2H on the back of property and ETP infrastructure construction starts. This is positive for Masteel, which is centrally located in the Klang Valley and enjoys a cost advantage over its competitors.
- Property - The outlook for the property sector is very positive as the proposed ETP rail and road infrastructure projects will greatly improve accessibility while the targeted rise in population in Greater KL from 6m to 10m by 2020 will boost demand. Also, the steady economic outlook and buoyant stock market augurs well for property demand. Leading developers are targeting record launches in 2011 and the strong sales will filter through to higher demand for building materials.
- Construction – We expect 2010's positive momentum to continue in 2011. Major projects in 2011 include the RM50bn KL MRT, the RM16.5bn high speed rail project and the RM1.6bn-2bn Package 2 of the LRT upgrade. Notable contracts given out in 2010 totalled RM8.7bn and we expect c.RM114bn of mega projects to be implemented over the next five years.
- **Cost advantage.** Masteel uses an electric arc furnace (EAF) to refine scrap steel into steel billets, which are, in turn, rolled into steel bars for use in the property and construction industries. Masteel's analysis suggests that at current prices, production cost for the EAF steelmaking process is US$30/mt lower compared to the direct reduction method and US$45/mt lower than the blast furnace process. The lower cost arises from EAF's use of scrap as feedstock instead of iron ore. Historically, scrap price increases have lagged behind iron ore price increases because 1) iron ore is imported from Brazil and Australia while scrap is sourced locally and 2) iron ore prices are volatile as supply is controlled by three major players (Rio Tinto, Vale and BHP Billiton).

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Comparison of raw material costs

(US$/metric tonne)	Blast Furnace	Direct Reduction	Electric Arc Furnace
Raw materials	Iron ore Metallurgical coke	Iron ore pellets Coal, natrual gas	Scrap metal Electricity
Production costs	685	670	640
Billet price (fob)	670	670	670
Spread	(15)	0	30
Malaysian mills	Ann Joo, Lion (in progress)	Kinsteel, Lion, Perwaja	Southern Steel, Masteel
COGS composition			
Transportation	1%	1%	1%
Labour	2%	3%	2%
Electricity	-	-	7%
Iron ore	41%	33%	-
Coal, natural gas	-	38%	-
Scrap metal	11%	-	68%
Metallurgical coke	21%	-	-
Overheads, consumables	24%	25%	23%
Total	**100%**	**100%**	**100%**

Source: Masteel investor presentation

- **Iskandar commuter rail network (CRN) proposal.** On 19 Jan, Masteel and KUB Malaysia Bhd (KUBM MK; Not Rated) formed a 60:40 joint venture Metropolitan Commuter Network Sdn Bhd (MCN) to submit a detailed proposal to supply and operate a world-class commuter train network in the Iskandar Development Region. In Feb 2011, a senior official at Johor's State Economic Planning Unit (Upen) said that other bidders are also likely to submit proposals. To our knowledge, there have been no other bids for the Iskandar rail project.
- Key points about the MCN proposal are:
  - The MCN proposal involves building and operating a 100km intra-city commuter rail network (CRN) system in Iskandar Malaysia and to Woodlands, Singapore. The project cost is valued at RM1.0-1.3bn.
  - The CRN will use Keretapi Tanah Melayu Bhd's (KTMB) existing railway track and land reserves. There will be up to 25 commuter stations in major towns in the Iskandar Malaysia region, with the main depot located in Kempas Baharu.
  - The project has two components: the "build-transfer" of the rail transit infrastructure and the "own-operate" of the intra-city train system. The project is to be undertaken in two phases and is expected to be completed within 24 months from project commencement. The Iskandar rail project is expected to be awarded by June-July 2011.
  - The "build-transfer" portion of the CRN will be funded by project financing under the federal government's public-private partnership scheme while the "own-operate" portion of the CRN will be funded by MCN and will be a 27-year concession.
  - We understand that MCN is negotiating a funding package for the "own-operate" portion that will involve 70% debt and 30% equity.
  - If the Masteel/KUB JV wins the project, consolidated proforma gearing is expected to increase from 0.5x currently to over 1.0x. This is within management's acceptable range and will not hinder the company from pursuing other growth opportunities during the "build-transfer" period of the rail project.

Iskandar Malaysia intra-city rail transit network

Source: Masteel investor presentation, Iskandar Malaysia

Valuation

- By 2012, we expect Masteel to expand its billet capacity by 30% to 650k metric tonnes and the capacity of its rolling mill by 43% to 500k metric tonnes. In comparison, Ann Joo has a billet capacity of 680k metric tonnes p.a. and three rolling mills with an annual capacity of 580k metric tonnes. Masteel's rolling mill utilisation rates are expected to remain high at 85%, underpinned by the property boom in the Klang Valley. Core earnings (ex-CRN) are expected to double from FY10 to FY12, which we believe will drive valuations and re-rate the stock.

Valuation of Malaysia's steelmakers

(RM m)	Ann Joo	CSC	HiapTeck	Kinsteel	Lion Ind.	Masteel	Mycron	Perwaja	S.Steel	Average
Fiscal year end	Dec	Dec	July	Dec	June	Dec	June	Dec	Dec	-
Market cap	1,573.4	684.0	356.9	875.7	1,313.8	295.1	145.0	557.2	985.6	754.1
(Last 12 months)										
Revenue	1,831.9	1,034.7	1,065.3	1,633.5	5,057.8	1,004.8	465.4	1,436.1	2,022.3	1,728.0
EBITDA	83.2	127.2	92.3	149.8	489.4	64.0	44.0	93.2	114.4	139.7
EBTIDA margins (%)	5%	12%	9%	9%	10%	6%	9%	6%	6%	8.0%
Pretax profit	139.9	94.8	67.7	(90.0)	515.8	30.1	32.3	(63.7)	8.8	81.7
Net profit	120.0	69.2	50.7	(33.1)	361.5	28.2	25.5	(63.8)	17.2	63.9
P/E (x)	13.1	9.9	7.0	nm	3.6	10.5	5.7	nm	57.4	17.8
P/NTA (x)	1.4	0.8	0.6	1.1	0.4	0.6	0.6	0.6	1.2	1.0
Net debt / (cash)	1,399.5	(290.8)	339.1	1,769.4	137.1	209.6	192.7	927.2	730.3	601.5
Net gearing (%)	132.0%	net cash	52.4%	229.3%	4.5%	43.8%	74.3%	103.8%	96.8%	92.1%

Source: Bloomberg, CIMB Research

- **Strong core earnings growth.** Masteel's core net profit is set to rebound from a loss of RM8.1m in 2009 to RM80m-90m in 2012, underpinned by the company's capacity expansion plans. Using 2010 as a base, this implies a 2-year FD Core EPS CAGR of 49%. Despite Masteel's earnings growth potential, its CY12 P/E of 4.8x is 30% below Ann Joo's P/E of 7.0x and 60% below the KLCI's P/E of 12.9x.
- **Trading at a discount.** Masteel trades at discounts to its peers. Its 0.6x P/NTA and 10.5x FY10 P/E are 40% lower than the sector average. Also, Masteel's net gearing of 43.8% is lower than the sector's 92.1%.
- **Masteel valuation.** Applying 10.2x P/E to an FD core EPS of 29 sen for FY12, we arrive at a value of RM2.95, implying 110% upside. Our target P/E of 10.2x is based on a 30% discount to our KLCI target P/E of 14.5x and is in line with our valuation for small-and mid-cap stocks. In comparison, Ann Joo is valued at a forward P/E of 13.1x or a 10% discount to our KLCI target.

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Valuation

- **CRN impact.** The above valuation excludes the Johor rail project that Masteel and KUB are bidding for. Masteel hopes the CRN operations will contribute net profit of RM40m-45m p.a. from FY12 onwards. Masteel's 60% portion works out to RM24m-27m p.a., adding 8.4 sen to its FD EPS. Should the Masteel/KUB JV win the Iskandar rail project, Masteel's FY12 FD core EPS would increase by 29% to 37.4 sen. At a 10.2x forward P/E, Masteel could be valued at RM3.80, implying 170% upside.

Masteel's earnings forecast and P/E valuation

Masteel	2008	2009	2010	2011F	2012F	2yr CAGR
Net profit (RM m)	79.3	(8.1)	28.2	52.0	92.0	
EPS (sen)	37.6	(3.8)	13.4	24.7	43.6	81%
EPS growth (%)	+79%	-110%	+248%	+85%	+77%	
P/E (x)	3.7	(36.5)	10.5	5.7	3.2	
Core EPS (sen)	37.6	(3.8)	19.6	24.7	43.6	49%
Core EPS growth (%)	+79%	-110%	+412%	+26%	+77%	
Core P/E (x)	3.7	(36.5)	7.1	5.7	3.2	
FD EPS (sen)	25.1	(2.6)	13.1	16.4	29.1	
FD P/E (x)	5.6	(54.7)	10.7	8.5	4.8	
KLCI CY12 market target P/E					14.5	
Masteel discount to KLCI					30.0%	
Masteel CY12 target P/E					10.2x	
Masteel value based on FY12 FD EPS (RM)					2.95	
* Impact of CRN project award on Masteel's value						
Potential FD EPS from CRN operations (c.RM26.2m p.a.)					8.3	
Resulting Masteel FD EPS (sen)					37.4	
Implied Masteel FD P/E (x)					3.7	
Potential Masteel value including CRN earnings (RM)					3.80	

Source: Masteel investor presentation, CIMB Research, Bloomberg

- **Warrants offer additional leverage.** For investors with higher risk appetite, Masteel's five year warrants are an attractive alternative. The warrants are deep in the money and will not expire until Oct 2015.

Profile of Masteel's warrants

Warrants outstanding (m)	105.4	Style (American o/ European)	American
Issued on	27-Oct-10	Strike price (RM)	0.67
Issue price (RM)	0.18	Conversion ratio	1 for 1
Maturity date	26-Oct-15	Convertible to	New ord. shr's
Years to maturity	4.55	To be settled by	Cash

Source: Bursa Malaysia, Bloomberg

- **Conclusion.** Masteel aims to be Malaysia's second largest steelmaker in terms of capacity by FY12. It is also looking to double net profits to RM80m-90m by then. We believe Masteel's targets are achievable as this merely returns the company to FY08 numbers. Should margins return to the 2008 levels, profits could be much higher given that its billet capacity will be 85% higher than in 2008. Also, the company's capacity expansion will be underpinned by higher steel demand due to property launches and ETP infrastructure project starts.
- Masteel is trading at 0.6x NTA, a 40% discount to the sector average (Figure 4). Also, as a result of the 48% annual net profit growth, it is trading at a forward P/E of only 4.8x. We value Masteel at RM2.95, based on a forward P/E of 10.2x or 30% below our CY12 target market P/E of 14.5x. This implies 110% share price upside. Masteel's valuation discount is wider than Ann Joo's 10%. Should it succeed in its bid for the Iskandar rail project, its FY12 FD core EPS would rise by 29% to 37.4 sen, implying a value of RM3.80 or hefty upside of 170%.

Financial summary

FYE Dec	2006	2007	2008	2009	2010
Revenue (RM m)	362.2	548.0	881.2	687.3	1,004.8
EBITDA (RM m)	56.7	74.8	114.8	21.7	64.0
EBITDA margins (%)	15.7%	13.6%	13.0%	3.2%	6.4%
Pretax profit (RM m)	30.0	46.2	85.7	(8.5)	30.1
Net profit (RM m)	30.0	44.3	79.3	(8.1)	28.2
EPS (sen)	14.2	21.0	37.6	(3.8)	13.4
EPS growth (%)	+29%	+48%	+79%	-110%	+248%
P/E (x)	9.8	6.7	3.7	(36.5)	10.5
Core EPS (sen)	14.2	21.0	37.6	(3.8)	19.6
Core EPS growth (%)	+29%	+48%	+79%	-110%	+412%
Core P/E (x)	9.8	6.7	3.7	(36.5)	7.1
Gross DPS (sen)	1.6	2.3	2.5	1.0	-
Dividend yield (%)	1.1%	1.6%	1.8%	0.7%	0.0%
P/NTA (x)	1.0	0.8	0.6	0.7	0.6
ROE (%)	10.5%	13.5%	20.2%	-1.9%	6.3%
Net gearing (%)	60.9%	54.8%	52.9%	55.9%	43.8%
P/CF (x)	nm	23.2	20.1	5.7	12.6
EV/EBITDA (x)	6.1	5.9	3.1	19.7	7.1

Source: Company, CIMB Research, Bloomberg

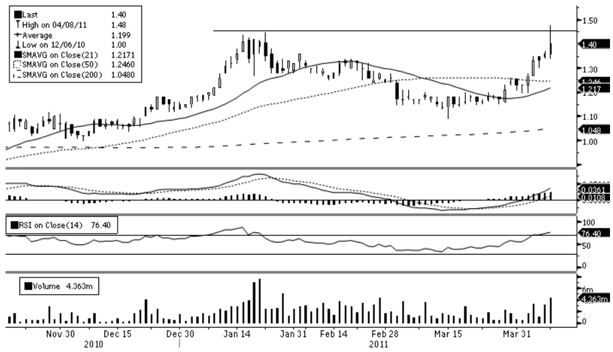
Sector comparisons

	Bloomberg ticker	Recom.	Price (Local)	Target price (Local)	Mkt. cap (US$m)	Core P/E (x) CY2011	Core P/E (x) CY2012	3-yr EPS CAGR (%)	P/BV (x) CY2011	ROE (%) CY2011	Div yield (%) CY2011
Malaysia Steel Works	MSW MK	NR	1.40	N/A	97	5.7	3.2	49.1	N/A	N/A	N/A
Ann Joo	AJR MK	TB	3.01	3.74	521	10.0	7.0	28.5	1.5	15.3	5.6
Lafarge M Cement	LMC MK	N	7.49	8.24	2,106	14.2	10.4	28.4	1.9	13.7	5.6
Tasek	TC MK	O	8.90	9.70	364	10.3	10.0	5.8	1.1	14.6	3.4
Simple Average (ex-Masteel)						**11.5**	**9.1**	**20.9**	**1.5**	**14.5**	**4.9**

O = Buy, N = Hold, U = Sell, NR = Not Rated, TB = Trading Buy and TS = Trading Sell

Source: Company, CIMB Research

Technicals



Source: Bloomberg, CIMB Research

- **To test 2008 highs soon.** Masteel's share price broke out of its downtrend from the RM1.45 Jan 2011 high two weeks ago. Since then, it has been on a gradual uptrend and is currently above the 50-day SMA of RM1.25. This is a bullish sign for the stock. Also, its weekly chart shows that the MACD is on the verge of confirming its bullish "golden cross" while the RSI has already broken out. Our first target is the Jan 2011 high of RM1.45, which we believe is easily achievable. Masteel's next level is the 2008 high of RM1.59 which we expect the stock to challenge. A significant breakout above the 2008 high would be bullish as this is Masteel's all-time high. From then on, there are no more 'known' resistances as share overhang would have been eliminated.