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OSK

Sector Update

Ng Sem Guan
+60 (3) 9207 7678
semguan.ng@my.oskgroup.com

Steel

NEUTRAL

PM Listens to Integrated Steel Mills' Wish

Malaysia Steel Association (MSA), comprising membership of most of the integrated steel mills in Malaysia, was officially launched yesterday. The association took the opportunity to convey to the Government its wish-list, which Prime Minister Datuk Seri Najib Tun Razak acknowledged in his speech. While we are encouraged by the immediate verbal commitment on some of the issues raised by MSA, we think any action to be taken would still be subject to approvals by the respective authorities, which may be arduous and may take time. Furthermore, we are cautious on the short to medium term outlook for steel mills, particularly in 2H10, until the upcoming new Lunar Calendar Year starts in February 2011, on sluggish steel prices and demand. Hence we maintain our NEUTRAL stance on the sector.

New steel association. We attended the Gala Dinner that marked the official establishment of the Malaysia Steel Association (MSA) yesterday. MSA was established with the objective of building on the combined strength and resources of the upstream steel companies to better compete in the global market. Through the joint efforts and synergy of the member companies, MSA aims to re-define the industry in terms of providing leadership and enhancing the standards of the steel making industry. MSA members include most of the integrated steel mills in the country, namely Amsteel Mills SB, Ann Joo Steel Bhd, Ann Joo Integrated Steel SB, Antara Steel Mills SB, Kinsteel Bhd, Malaysia Steel Works (KL) Bhd, Megasteel SB, Perfect Channel SB and Perwaja Holdings Bhd.

MSA's "wish list". MSA made full use of yesterday's event to convey its "wish list" to the Government via its press release and welcome speech by its President, Tan Sri William Cheng. We are surprised that some of the issues raised by the association were clearly noted by the Prime Minister Datuk Seri Najib Tun Razak in his speech, which was read out by Minister in the Prime Minister's Department, Tan Sri Nor Mohamed Yakcop.

More land for iron ore and coal mining? Among others, the Prime Minister pledged to represent the Federal Government to encourage states with iron ore and coal reserves to allocate more land of economic size to the local steel manufacturers to undertake commercial mining to enhance their steelmaking operations. This is good news, especially for the iron makers that include Lion Group and Perwaja, which have recently made known their intention to venture into iron ore mining and then use the resources in their proposed iron ore pelletization plants. Meanwhile, Ann Joo is also set to benefit as it is commissioning its new 450 cubic meters mini Blast Furnace which is in need of iron ore as its plant's main feed. However, as mining rights are under state government jurisdiction, that matter may become even more sticky, particularly for states that are currently under opposition party administration, and thus an official agreement may take longer than expected.

Government to study duty structure for iron ore and scrap metal. The PM also gave his commitment to assist local steel mills to enhance their competitive edge wherever possible, including helping them to secure supply of locally available materials such as scrap required for steelmaking. In this regard, he said the Government would study the duty structure for iron ore and scrap, with the view of making available the supply of such essential raw materials for priority use of the local industries. The commitment is obviously welcome as some scrap has been exported since the Government last liberalized the scrap market but we suspect the leakage may be limited given the scarce supply of local scrap. As for iron ore, the potential imposition of export duty is certainly bring relief to iron makers which are in the midst of undertaking investments in iron ore pelletization plant..

Competitive energy cost. The Government also took note of steel and iron makers' request to set electricity and natural gas tariffs that are comparable to those in neigbouring countries and countries producing natural gas respectively in order to create a level playing field for the steel industry. We believe this is obviously a big relief to Lion Diversified Holding and Perwaja since natural gas is their main burning energy and production cost for their Direct Reduction plants has been rumored to be in for a tariff increase. Nonetheless, we think the "comparable tariff" referred to by the PM may be subjective, especially during the official negotiations with Petronas. That aside, Datuk Seri Najib also promised to get the relevant authorities to look into the request to extend the off-peak hours rate to Saturday, Sunday and public holidays. Tenaga is currently giving discounts of some 50% from the normal tariff during off-peak hours. Therefore, any cost savings are obviously welcome, especially since steel mills consume approximately 600 to 700 kW/hr of electricity for every tonne in steelmaking although the quantum of savings is dependent on the percentage of steel actually produced during off-peak hours. As this translates into some 7% of production cost, steel mills may not fully benefit from the off-peak rate by running 100% production during the down cycle as this may bar them from enjoying special tariffs when total electricity cost is less than 5% of its production cost. The issue also become more complex following the surge in scrap and iron ore cost during the last decade, as material now represent more than 70% of their production cost. Thus any further surge may mean steel mills will be struck out from the list of those enjoying special tariff.

Quality check may not stop influx of imports. As for the Prime Minister's promise to ensure the relevant authorities take appropriate measures through enforcement of rigorous quality standards on imports of steel products to prevent the market from being flooded with sub standard material, we think this may have little impact in stopping the influx of imports as this is already happening. We believe that so long as domestic steel prices offer enough spread for arbitrage opportunity, this may be followed with the imports by traders, which would eventually to close the lucrative gap.

OSK Research Guide to Investment Ratings

Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels

Sell: Share price may fall by more than 10% over the next 12 months

Not Rated (NR): Stock is not within regular research coverage

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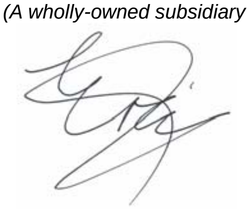

Chris Eng

Kuala Lumpur	Hong Kong	Singapore	Jakarta	Shanghai
Malaysia Research Office OSK Research Sdn. Bhd. 6th Floor, Plaza OSK Jalan Ampang 50450 Kuala Lumpur Malaysia Tel : +(60) 3 9207 7688 Fax : +(60) 3 2175 3202	**Hong Kong Office** OSK Securities Hong Kong Ltd. 12th Floor, World-Wide House 19 Des Voeux Road Central, Hong Kong Tel : +(852) 2525 1118 Fax : +(852) 2810 0908	**Singapore Office** DMG & Partners Securities Pte. Ltd. 20 Raffles Place #22-01 Ocean Towers Singapore 048620 Tel : +(65) 6533 1818 Fax : +(65) 6532 6211	**Jakarta Office** PT OSK Nusadana Securities Indonesia Plaza Lippo, 14th Floor, Jln. Jend. Sudirman Kav 25, Jakarta 12920 Indonesia Tel : +(6221) 520 4599 Fax : +(6221) 520 4598	**Shanghai Office** OSK (China) Investment Advisory Co. Ltd. Room 6506, Plaza 66 No.1266, West Nan Jing Road 200040 Shanghai China Tel : +(8621) 6288 9611 Fax : +(8621) 6288 9633