REVISED POSITIVE OUTLOOK IN MOST STEEL COMPANIES IN 2017

Most steel companies had seen a price recovery this year after experiencing gloomy outlook for past few years. The revised outlook seen in this year could be attributed to the following reasons:-

i. The companies within the steel industry had always been facing competition from China's steel maker as the cost of production is lower. The announcement by Chinese steel makers to reduce surplus capacity and reduction in exports of steel products from China has benefited domestic steel producers.

ii. Safeguard measures implemented by the Government of Malaysia on 23rd September 2016 relating to the duty imposed on imported steel products, protects Malaysia's steel industry from cheap imports allowing the local Malaysian companies in the steel industry to be competitive in pricing.

INVOLVEMENT OF A STEEL COMPANY

Upstream activities – Such companies are involved in steel making and owns steel mills. Basically, these companies manufacture steel bars from mixture of iron pellets (Fe_2O_3), coke (C) and limestone ($CaCO_3$) and burnt in a blast furnace. The molten mixture is then cooled and the steel bars are known as **Hot Rolled Steel** ("**HRS**").

Midstream activities and downstream activities – These companies are involved in converting the HRS to **Cold Rolled Steel** ("**CRS**"). Also, these group involves further steel processing and product manufacturing of tubes and pipes.

Essentially, **CRS** is even on its surface and command higher pricing than HRS. CRS is used in automotive, electrical appliances, furniture and machine equipment where precision of uniformity of thickness is an important criterion. As a comparison **HRS**, with less uniformity in its thickness, is used in railings and gates.

CLOSURE OF MEGASTEEL SDN BHD BENEFITED STEEL COMPANIES THAT PRODUCE CRS – EXAMPLE MYCRON STEEL BHD AND CSC STEEL HOLDINGS BHD

Previously, Megasteel Sdn Bhd, a member company of the LION Group, produced approximately 70% of Malaysia's requirement of HRS. The balance requirement of HRS is produced by **Southern Steel Bhd.** However, as from August 30, 2016, Megasteel Sdn Bhd ceased its manufacturing operations at Banting, Klang.

The closure of its plant has in a way benefited some other steel companies such as **Mycron Steel Bhd** and **CSC Steel Holdings Bhd** which are dependent upon the **HRS** to produce **CRS**. This is especially true for Mycron Steel Bhd whereby its annual net margin improves by about 2% compared to the past.

Now, such companies could purchase from overseas as there was some protection awarded to protect the local HRS producer back then requiring them to buy from local HRS producer. Mycron Steel Bhd, CSC Steel Holdings Bhd, and other companies that require HRS, are now able to buy their raw material, i.e. HRS at lower cost from overseas suppliers.

FINANICAL ANALYSIS OF STEEL COMPANIES IN MALAYSIA

Tabulated below is a table detailing key financial and valuation metrics of 12 listed companies in Malaysia involved in various activity in the value chain of the steel industry, i.e. upstream, midstream and downstream.

I wish to share with readers here that when all the indicators are read together, it does provide some predictive capabilities of the financial health of a company and its fair value. Before, I provide the examples, below are some brief explanation of the indicators used:-

I. Valuation metrics – P/E and P/B

As a value investor, we would prefer a **low** P/E and P/B which means that it is relatively cheaper in value. However, P/B should be read together with the difference between a company's return of investment ("**ROE**") and its required rate of return ("**r**") to compensate for its business risk. Sometimes, a low P/B is considered fair for companies having a negative difference of ROE and r. These companies are trading below its one-time multiple for reason that these companies could not generate the required rate of return demanded by investors.

II. Net cash position

A net cash position is preferred over a company having a huge net liability.

III. Altman Z-Score

When analyzing the Altman Z-Score of a company, the lower the value, the higher the probability that a company is heading toward bankruptcy.

TABLE OF RESULTS FOR UPSTREAM STEEL COMPANIES – ALL FAIRLY PRICED EXCEPT KINSTEEL BHD, NOW PN17

LISTED COMPANIES	Marrket capitalization, **RM million**	Closing Price as at 16 October, 2017, **RM**	TWR, % from 1 January 2017	P/E	P/B	P/B Justified	Net margin, %	Net Cash / (Net Borrowings) **RM million**	Atlman Z-Score
Upstream									
Ann Joo Resources Bhd	1,979	3.70	110%	11	1.7	1.7	10%	(851)	2.4
Southern Steel Bhd	959	2.22	123%	10	1.3	1.8	4%	(994)	1.7
Lion Industries Corporation Bhd	1,005	1.40	387%	9	0.6	0.6	4%	102	1.9
Malaysia Steel Works (KL) Bhd	410	1.32	133%	12	0.7	0.5	2%	(299)	1.8
Kinsteel Bhd	42	0.04	-96%	Loss	0.0	(311.3)	-139%	(800)	(0.6)

Tabulated by AER

CONCLUSION DRAWN ON UPSTREAM ACTIVITIES

1. All the companies in the upstream activities are **fairly priced** at this moment.

2. **An Joo Resources Bhd** has reported the highest net profit margin and Atlman Z-Score compared to its peers. The financial indicators indicate that at the moment, Ann Joo Resources Bhd is fairly priced.

3. **Kinsteel Bhd's** share price dropped substantially most likely due to the company has been categorised as PN17 company since 26 October 2016. It is interesting to note that its Altman Z-Score is on a downward trend since FY 2009 and at negative region since FY 2014. Its risk of bankruptcy was reflected few years back before it ended up in financial difficulties last year.

TABLE OF RESULTS FOR MIDSTREAM AND DOWNSTREAM STEEL COMPANIES – POSITIVE INDICATORS NOTED FOR BOTH CHOO BEE METAL INDUSTRIES BHD AND CSC STEEL HOLDINGS BHD

LISTED COMPANIES	Marrket capitalization, **RM million**	Closing Price as at 16 October, 2017, **RM**	TWR, % from 1 January 2017	P/E	P/B	P/B Justified	Net margin, %	Net Cash / (Net Borrowings) **RM million**	Atlman Z-Score
Midstream and Downstream									
Mycron Steel Bhd	220	0.78	-27%	7	0.6	2.9	5%	(18)	2.4
Leon Fuat Bhd	265	0.86	122%	5	0.9	2.8	11%	(155)	2.7
Prestar Resources Bhd	284	1.40	92%	6	1.1	1.9	6%	(232)	2.3
Leader Steel Holdings Bhd	82	0.64	116%	9	0.6	1.0	4%	(67)	0.6
CSC Steel Holdings Bhd	657	1.73	-16%	10	0.8	1.2	5%	219	6.9
Choo Bee Metal Industries Bhd	269	2.45	72%	9	0.6	0.7	8%	34	6.5
Hiap Teck Venture Bhd	519	0.40	70%	Loss	0.6	(1.6)	-10%	(370)	2.3

Tabulated by AER

CONCLUSION DRAWN FROM MIDSTREAM AND DOWNSTREAM ACTIVITIES

1. Two companies stand out as having good strong financial health namely **CSC Steel Holdings Bhd** and **Choo Bee Metal Industries Bhd**, both having negligible financial risk which is supported by net cash position.

2. In terms of valuation, **CSC Steel Holdings Bhd** and **Choo Bee Metal Industries Bhd** seems to be trading fair to its book value presently.

Generally, the steel industry in Malaysia is very much dependent upon local demand. The steel demand is directly related to the level of activity in the construction and infrastructure sector within Malaysia. Increasing public expenditure in construction and infrastructure will have a positive benefit to the sector. Example includes MRT II, LRT Line III, large property development projects such as Menara Warisan Merdeka, Tun Razak Exchange and the construction of the RM17 billion Pan Borneo Highway.

Factors that are negative to the steel industry include potential increasing cost of production such as electricity and iron ore prices may negatively effect on profitability and hence may cause an underweighting in this sector amongst investors.

END