CapitalBeat

by **Clement Chew**

Steel looks good

The steel sector on Bursa is poised for a re-rating. As the sector has been under-researched and overlooked, it may benefit investors to take a closer look.

The reasons are highlighted in the following.

1. China has cut capacity

To assess the prospects for the domestic steel sector, we need to understand the steel industry in China.

China accounts for half of the world's production of steel. Its total crude steel capacity of 1,130 million tonnes per annum is substantially higher than its current production of 800 million tonnes.

The Chinese government, in its 13th Five-Year Plan, it targets to reduce its steel capacity by 100-150 million tonnes. This translates to a reduction of 9-13% in capacity.

It is estimated that this will reduce global capacity by 4.5-6.5%. A recent report in the *South China Morning Post* said China has shut 42.4 million tonnes of steel capacity in the first half of the year. This is equal to 84% of the government's target for this year.

On the global stage, there are pressures for China to address its steel overcapacity.

In the previous two G20 Summit of global leaders, it was highlighted that overcapacity in steel was an issue that required a global response. The OECD-sponsored Global Forum on Steel Excess Capacity aims to develop concrete policy solutions by November. This will serve as the basis for tangible policy actions. The follow-up progress report is expected next year.

Based on pressures to advance its supply side reforms and considering China's more matured stage of industrialisation, it is reasonable to believe that the country's steel production has plateaued.

2. Exports from China have declined

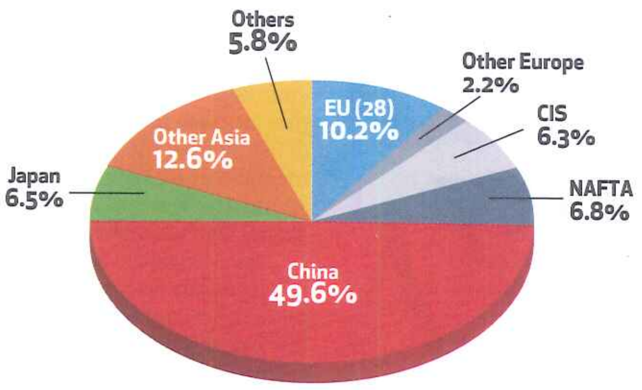
Malaysian steel producers have been negatively impacted by steel exports from China.

However, China's steel exports have declined from nearly 11 million tonnes in June last year to seven million tonnes in May this year.

This is an important change. An estimated 3% of China's exports go to Malaysia. Asean countries account for about 34% of China's steel exports.

Recently, the *Korea Economic Daily* reported a shortage of rebars in the country. This is not surprising as South Korea has been one of China's largest export markets for steel.

Crude steel production
World total: 1,621 million tonnes



Source: World Steel Association

3. Demand to surprise

The question is: Is China's steel consumption sustainable as its GDP growth starts to slow?

A source of new steel demand may come from China's One Belt One Road (OBOR) initiative. The latter has been likened to the United States' Marshall Plan – a US$13 bil aid package by the US to help rebuild Western Europe after World War II.

OBOR is a US$5 tril infrastructure spending programme, mainly in transport and energy, involving more than 60 countries across Asia, the Middle East, Europe and Africa. While these are early days, the OBOR initiative may benefit steel demand in the way China's industrialisation phase did between 2000 and 2014.

Finally, the World Steel Association forecasts global steel demand to grow by 0.4% this year. There is a risk that demand growth is being underestimated after the recent stagnation and considering the synchronised recovery in the developed economies.

4. Malaysian steel fundamentals have improved

The improved prospects for local steel players are based on four factors.

First, on April 13, the government implemented safeguard duties for certain steel products for three years. Duties for rebars were levied at 13.42%/12.27%/11.1% in years 1/2/3 respectively. For wire rods and deformed bar in coils, the duties were 13.9%/12.9%/11.9% in years 1/2/3 respectively.

This was an extension of a provisional set of safeguard duties which was imposed on Sept 27, last year.

The implementation of these safeguard duties has made the said categories of steel imports less competitive.

Second, China's steel prices have risen sharply since December last year. This has made China's steel exports more expensive and contributed to an estimated 28.9% year-on-year decline in exports in the first half of the year.

Malaysia's steel consumption was estimated at 12.7 million metric tonnes (mt) last year. However, our crude steel production is estimated at four milion mt per annum. This implies that over eight million mt of steel has been imported annually to meet local consumption. Local producers will benefit if steel imports from China decline.

5. Plant closures have reduced steel capacity

Third, capacity in the local steel industry has declined due to the closure of Megasteel's plant in September last year. The latter had 3.2/1.5 million mt of hot rolled coil (HRC) and cold rolled coil (CRC) capacity, respectively.

Additionally, the closure of Perwaja Steel's 1.5 million mt plant in December 2014 has reduced capacity in the long steel segment.

These two closures are significant if compared against the annual production of four million mt per annum in the country.

6. Demand from infrastructure projects

Fourth, an unprecedented number of large infrastructure projects will be implemented in Malaysia. The government has earmarked RM240 bil in rail-related projects alone.

They include the Kuala Lumpur-Singapore High Speed Rail (RM50-65 bil), East Coast Rail Line (RM55 bil), MRT Line 3 (RM35 bil), LRT3 (RM9 bil) and Gemas-Johor Bahru double tracking (RM8 bil).

Separately, a local bank estimates US$200 bil worth of large-scale projects will be implemented from the second half. It expects 20% of this amount to be awarded in the next six months.

The Construction Industry Development Board (CIDB) expects to see the construction sector grow by 8% to RM170 bil this year.

Finally, local steel consumption is expected to grow by 4.7% and 5.3% to 13.3 and 14 million mt in 2017/2018, respectively.

Time to revisit steel

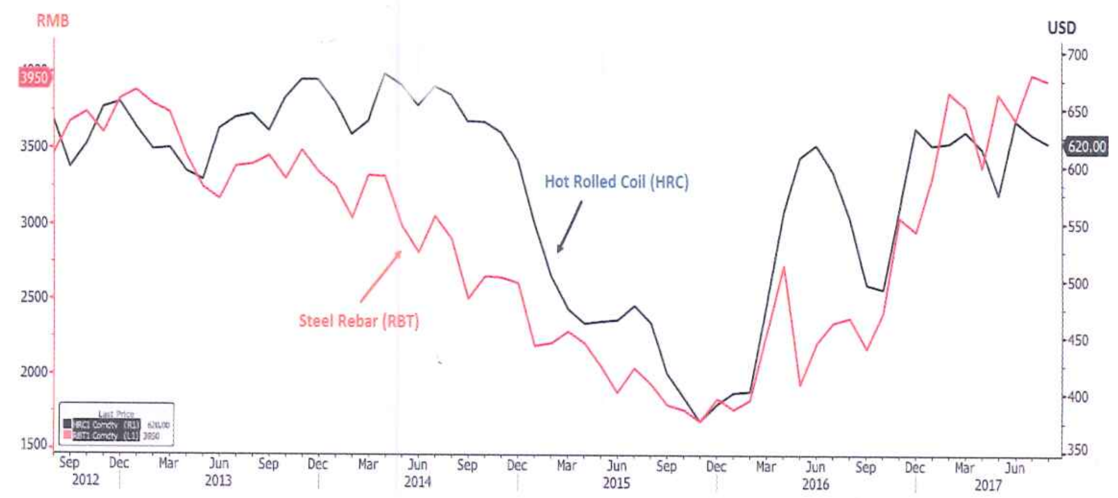
The improved prospects for the Malaysian steel sector are underpinned by a confluence of factors. China's supply side reforms will lead to lower exports. Locally, safeguard duties will protect domestic players while local steel demand is set to increase with the record spending on infrastructure projects. The closure of several local steel plants have reduced the industry's capacity.

Some steel stocks on Bursa are trading at 7-10x for CY 2018. This is an attractive 37% to 56% discount to the KLCI's PER of 16x in 2018.

The upcoming June quarter results may be lacklustre due to competition and lower sales in Q2. However, with improved fundamentals, the steel sector is set to record better earnings. FocusM

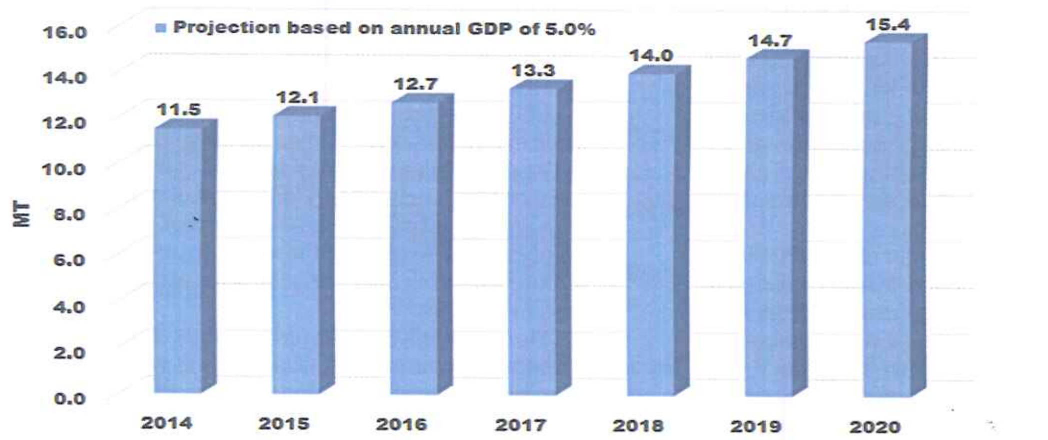
Clement Chew is CEO of Apex Investment Services Bhd. The views expressed are his own and do not necessarily reflect the position of his company. Apex is a unit trust management company and may have investments in the steel sector

Generic 1st 'HRC' Future vs Generic 1st 'RBT' Future



Source: Bloomberg, data as of 3.8.2017

Projected Malaysian steel consumption 2014-2020



Source: Malaysia Steel Institute