

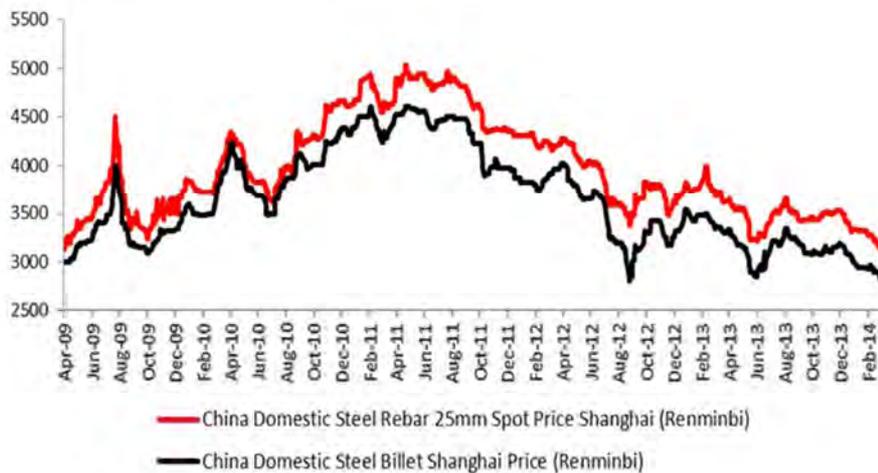
27 March 2014 | Sector update

STEEL Downward Spiral

Downgrade to NEGATIVE
(From NEUTRAL with negative bias)

- Steel product prices continued decline and spread between Billets and Steel Bars narrowed. Prices of steel products, namely Steel Bars and Billets have continued to trend downwards in recent months. Year-to-date based on Shanghai's prices, Billets and Steel Bars prices have declined to an average of RMB2,948 and RMB3,276 per tonne respectively as compared to RMB3,141 and RMB3,479 in 4QCY13. Chart 1 shows the continuation of downward price trend of Billets and Steel Bars. The spread between Billet and Steel Bar price has narrowed as depicted on Chart 2.

Chart 1: Price Trend of Billets and Steel Bars (in RMB)



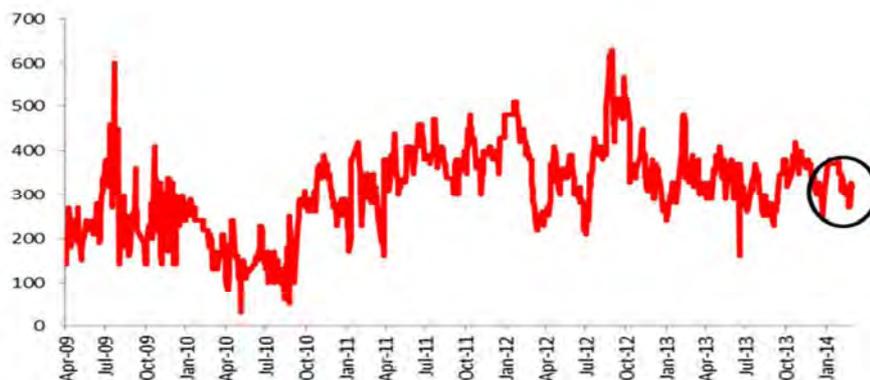
Source: Bloomberg, MIDFR

Table 1: Average price of Billets and Steel Bars by quarters

Average Price (RMB per tonne)	Billets	Steel Bars
1Q14*	2,948	3,276
4Q13	3,141	3,479
3Q13	3,198	3,493

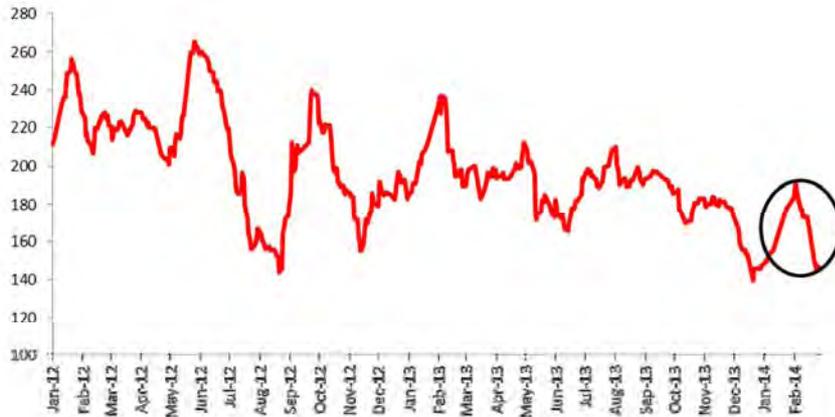
*Year-to-Date Average price. Source: Bloomberg

Chart 2: Spread between Steel Bars and Billets (in RMB)



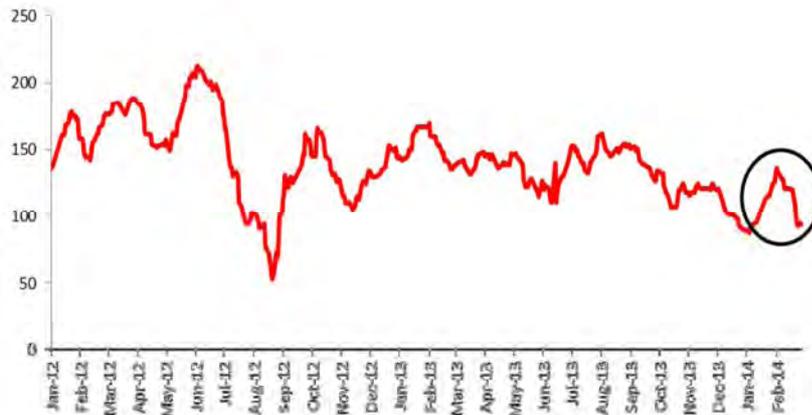
Source: Bloomberg, MIDFR

Chart 3: Spread between Steel Bars and Scraps (in USD)



Shanghai prices of Steel Bars have been converted from RMB into USD and compared to Scrap prices of equivalent currency. Source: Bloomberg, MIDFR

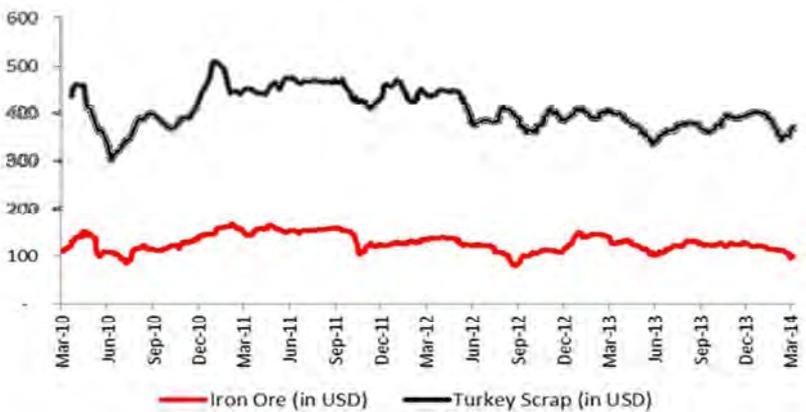
Chart 4: Spread between Billets and Scraps (in USD)



Shanghai prices of Billets have been converted from RMB into USD and compared to Scrap prices of equivalent currency. Source: Bloomberg, MIDFR

Chart 3 & 4 shows the spread between Steel Bars and Scraps and the spread between Billets and Scraps (in USD) declining. Volatility continues to be reflected by the prices of steel products.

Chart 5: Price Trend of Iron Ore and Scraps (in USD)



Source: Bloomberg, MIDFR

Table 2: Average price of Iron Ore and Scrap by quarters

Average Price (USD per tonne)	Iron Ore	Scrap
1Q14*	112	374
4Q13	123	389
3Q13	123	371

*Year-to-Date Average price. Source: Bloomberg

- **Raw materials, iron ore and scrap prices have also weakened.** Chart 5 shows the declining price trend of Iron Ore and Scrap. Year-to-date, Iron Ore and Scrap prices have declined to average of USD112 and USD374 per tonne respectively as compared to USD123 and USD389 in 4QCY13. Iron ore prices have been depressed due to weaker demand from China mills. Steel players have not been able to benefit from the decline in raw material prices as the average selling prices (ASP) for steel products, Billets and Steel Bars also trended lower as shown in Chart 1.

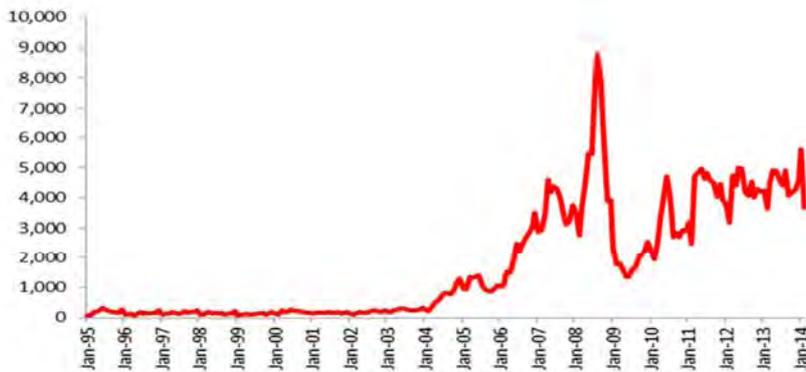
Chart 6: China's Crude Steel Production (in Thousand Tonnes)



Source: WSA

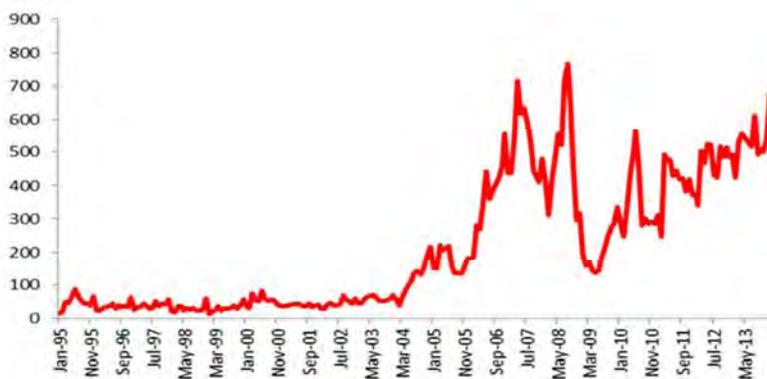
- **China crude steel production and export of steel production remained high.** China's crude steel production totaled 61,573 thousand tonnes and represented 47.4% of the world's crude steel production in Jan 2014, which is still high in our opinion.
- **The China's Industry and Information Technology Ministry (MIIT) vowed tougher measures to reduce the overcapacity situation in China.** MIIT vowed to implement tougher measures such as banning of new projects in the steel, cement, electrolytic aluminum, flat glass and shipbuilding industries before 2017. The Chinese government has accelerated its pace to reduce the excess capacity. Also, it plans to eliminate backward steel production capacities. However, we do not expect a quick solution to China's overcapacity problems and its steel production capacity is likely to remain high in the near term.
- **While Europe and US have shown signs of recovery albeit uneven, China's economic growth and that of the ASEAN economies have slowed down.** Slowing economic growth of China, the sector's largest steel consumer is likely to continue to dampen steel prices.

Chart 7: China's Export of Steel Products (USD Mil)



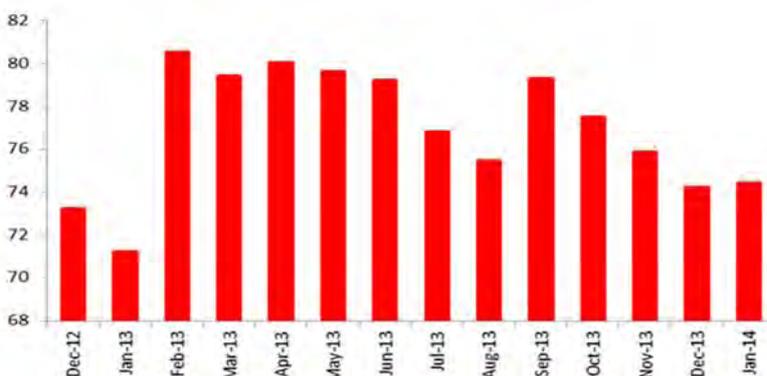
Source: CEIC

Chart 8: China's Export of Steel Products (Tonnes)



Source: CEIC

Chart 9: World Capacity Steel Utilisation (%)



Source: WSA

- **Downgrade Sector to NEGATIVE from NEUTRAL (with negative bias).** The sector is expected to remain challenged by the overcapacity of China's steel production and the slowdown of China's economy. Arising from this, we expect: i) raw materials prices to continue to be volatile, ii) dumping of cheaper steel products into the local market by foreign producers to persist; and iii) selling prices for steel products to remain weak.

We have turned more NEGATIVE on the sector. This is based on our concerns on China's economic fundamentals which have turned weaker. Manufacturing activity in China has slowed down with a lower Purchasing Manager Index (PMI) reading while measures have been introduced to clamp down shadow banking which will lower the country's credit growth. Also, reforms have been undertaken to address the country's high debt level. We gather that there already two defaults on corporate bonds, namely Shanghai Chaori Solar Energy Science & Technology (a Solar panel maker) and Zhejiang Xingrun Real Estate's bonds.

As average selling prices (ASP) of steel products locally tracks closely to the prices in the foreign markets. The imbalance between supply and demand in China is expected to continue to impact steel products prices. China's overcapacity of steel production was created during the investment boom and with generous subsidies in the country in the previous years without due consideration to the real market demand. Hence, the overcapacity of steel production in China will be difficult to unwind substantially in a short period of time against a backdrop of weaker market condition and demand for steel products. Real market demand for steel products has slowed down as compared to the time period when stimulus spending has been implemented globally.

We maintain our NEUTRAL call on Ann Joo (TP: RM1.25) as well as our SELL calls on Kinsteel (RM0.16) and Lion Industries Corp (LICB) (TP: RM0.43). We have downgraded LICB from NEUTRAL to SELL in the recent results review due to its weaker fundamentals with its steel operations still reporting losses as well as due to impairment losses from its investment in quoted shares which impacted its earnings.

We are now downgrading our rating for the steel sector from NEUTRAL (with negative bias) to an outright NEGATIVE. This is in line with our SELL calls for most of the stocks under coverage as well as due to concerns on the slower economic growth in China.

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STOCK RECOMMENDATIONS

BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	<i>Negative</i> total return is expected, by -15% or more, over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.

SECTOR RECOMMENDATIONS

POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.