# Margins of steel companies seen to ease moving into 2Q and beyond

**Building materials sector**

**Maintain overweight:** Steel bar prices declined in April 2018, reflecting softer steel prices in China, subdued domestic steel demand and expectations of rising domestic supply in the second half of 2018 (2H18). Although we expect margins to improve in the first quarter of 2018 (1Q18), margins may eventually contract from 2Q18 as average selling prices (ASP) decline and domestic supplies rise. Nevertheless, we do not envisage the worst case of industry capacity growth of 30%. We maintain "overweight" on the building materials sector but "market weight" on the steel segment.

We have turned more cautious on the outlook for local steel prices moving into 2H18 as rising steel supply could easily outstrip rising demand (supply expected to grow 16% in 2018). While the market has fully factored in the commencement of China-owned Alliance Steel, which could add up to 16% to existing capacity, Lion Industries Corp is also looking to significantly raise the utilisation rate at its Johor plant in 3Q18 (utilisation rate was 20% before it underwent heavy maintenance), and mulling restarting the Banting plant in 4Q18. Collectively, the three plants could effectively raise industry long steel capacity by 30%. The current estimated industry capacity utilisation is healthy. Nevertheless, we reckon that the worst case would not materialise, as Lion would need to consider the huge financial resources and long project payback period in restarting the Banting plant.

Based on our generic model, we think that steel companies may report another set of strong earnings for 1Q18 with gross profit per tonne potentially expanding to RM711 per tonne (4Q17: RM708 per tonne). However, margins would ease moving into 2Q18 and beyond, given softer steel ASP and rising domestic supply.

We retain our "overweight" call on the building materials sector but have become less optimistic about the steel segment, whose upside is capped by the influx of incoming supply in 2H18. We also believe that the incremental impact from industry consolidation in China is also limited as the plan for capacity cut is reaching its target. In addition, China's government has approved new steel capacity to replace the defunct ones which will come onstream between 2018 and 2023.

We maintain "buy" for Ann Joo Resources but reduce our target price (TP) to RM3.60 (previously RM4.50). We cut our price-earnings (PE) multiple from nine times previously (based on a five-year historical average from 2006 to 2010) to seven times based on a 10-year historical average from 1997 to 2006. This is mainly to capture a wider valuation horizon during the previous cycles as well as the period when investors were risk-averse on small-cap stocks.

Similarly, we also cut our TP on Choo Bee Metal Industries to RM2.70 (previously RM3.10) as we reduce the PE multiple from seven times initially to six times based on 0.5 standard deviation above its 10-year historical average. — *UOB Kay Hian, May 3*