Ezz Steel

بلوم مصر لتداول الأوراق المالي
BLOM EGYPT SECURITIES

BLOMINVEST BANK

Alert on H1 2014 Earnings		Share Price (EGP):	18.49
Sector:	Basic Materials & Industrial Products	Target Price (EGP):	18.06
Country:	Egypt	Upside:	-2.4%
Date:	October 07, 2014	Recommendation:	HOLD

Downgrading Ezz Steel to a HOLD rating with a Target Price of EGP 18.06 per share on weaker outlook

We downgrade Ezz Steel to a HOLD rating, revising down our target price to EGP 18.06 per share as we view the current share price as fairly reflective of the market and company risks at hand. We also hold our expectations of feeble financial results in 2014 following the negative impact of the interrupted availability of natural gas, the main energy source used in steelmaking.

During H1 2014, the declining gas production on top of government's accumulation of arrears equal to $6 billion due to foreign oil companies, have combined with increasing consumption to create Egypt's worst energy crisis in decades. The Egyptian industrial sector was negatively affected as the Ministry of Petroleum decided to stop pumping natural gas to a number of plants in order to provide greater quantities to electricity stations. This has translated into lower profitability in the sector with companies forced to shift from natural gas to more expensive commodities. Although Egypt is actively looking for solutions through the speeding up of natural gas exploration and the financing of payments to foreign oil companies from banks, we believe these efforts will more likely materialize in the long term.

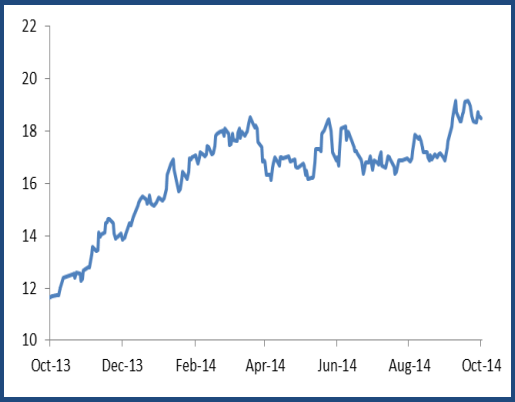
In this context, Ezz Steel, who was making high profits by getting the natural gas subsidy from the Egyptian government and selling its products locally at the international market prices, will now see its profitability shrinking more from the recent government's decision to raise energy prices. Moreover, we believe Ezz Steel's Direct-Reduced Iron factories, which rely on natural gas and previously saved considerable costs, will continue to operate at low capacity utilization rate at least until the natural gas supply recovers. Hence, we expect Ezz steel to continue to record a weak performance during 2014, suffering from gas shortages, dwindling levels of production and sales, and a negative profitability.

On the other hand, the release of Ahmad Ezz from prison coupled with news related to his return onto the board gave a boost to the company's shares price. Yet, we believe investor confidence in the company will remain weak until further clarity is presented. We also continue to perceive pressure from the risks associated with the ability of the company to hold on to its largest and most profitable subsidiary EZDK on top of the pending cases filed against Ahmad Ezz, which include charges of defrauding the public, money laundering, illicit gains and steel monopoly.

Share Data

Bloomberg Symbol	ESRS EY
Reuters Symbol	ESRS.CA
Market Cap (EGP)	10,044,970,349
Number of Shares	543,265,027
Free Float	35%
Price-to-Earnings 2014e	25.22
Price-to-Book 2014e	1.62

Share Performance



Source: Reuters

1 Month Return	8.5%
3 Month Return	11.9%
6 Month Return	3.4%
12 Month Return	58.7%
52 Week Range	11.65 – 19.17

Source: Reuters

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Performance and Forecasts

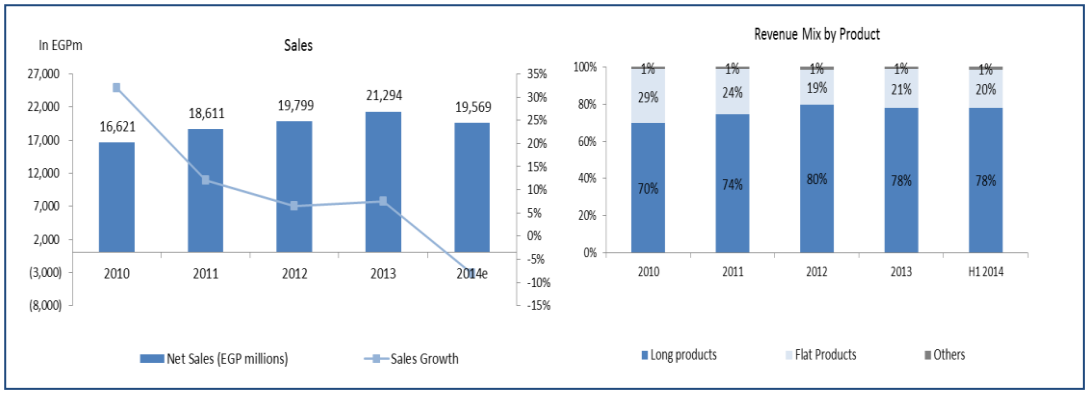
In EGP millions	2011	2012	2013	2014e
Revenues	18,611	19,799	21,294	19,569
Gross Profit	2,207	1,690	2,331	1,174
Gross Profit Margin %	12%	9%	11%	6%
Net Income	202	8	398	(217)
Profit Margin %	1%	0%	2%	-1%

Source: Ezz Steel, Blominvest

FINANCIAL HIGHLIGHTS

Shortage in natural gas supply drags Ezz revenues

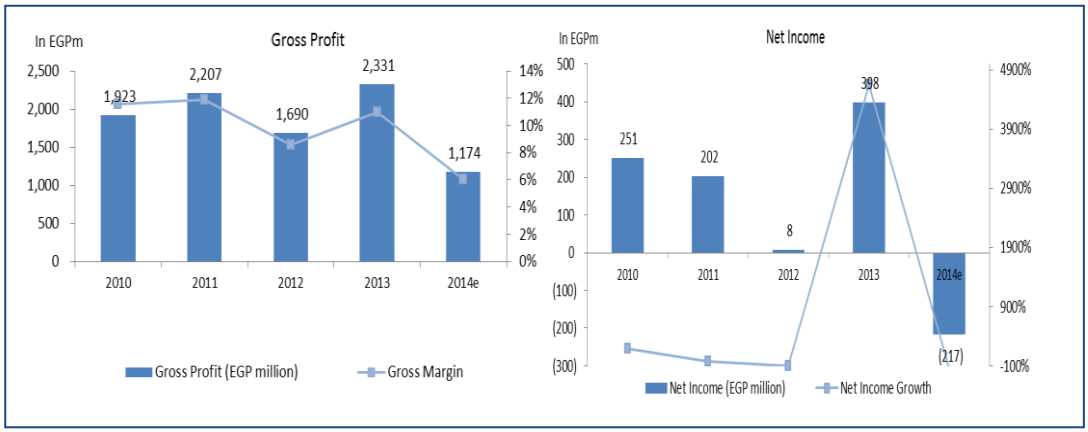
Ezz Steel registered a noticeable poor performance during H1 2014 with total production falling by 3.1% y-o-y to 4.04 million tons as the shortage of natural gas supply on top of power cuts led to a massive loss of production during peak hours at all Ezz Steel plants. As a result, Ezz revenues plummeted by 7.9% y-o-y to reach EGP 10.3 billion in H1 following a yearly 8.5% drop in sales volumes to 2.3 million tons. Long steel products, which are used in construction, declined by 8.1% y-o-y to 1.8 million tons, while flat sales volumes, typically used in industrial goods, edged down by 10.1% over the same period to 470 thousand tons following lower production at EZDK. Local sales constituted around 87% of the Egyptian steel maker's top-line following strong local demand, while the remaining 13% were mostly attributed to export markets led by Europe and the MENA region. As for long products prices, weakness in the international steel markets dragged prices down and made it more attractive to sell locally. Flat export prices fell by 1%, while domestic prices rose by 2% backed by robust demand following the government's large scale infrastructure projects. Looking forward, we expect revenues to drop by 8.1% in 2014 to EGP 19.6 billion, mainly hit by the disrupted availability of utilities in the country.



Source: Ezz Steel, Blominvest

Ezz Steel turns to a loss on lower capacity utilization

Ezz Steel endured a challenging H1 as the shortage of natural gas pressured margins by forcing the company to import more expensive scrap, steel billets and direct reduced iron. Production costs surged to 94.2% of sales in H1 2014 from 87.2% a year earlier, reflecting the current low capacity utilization level at all facilities. Consequently, the company's gross profit margin declined drastically from 12.8% to one of its lowest levels of 5.8%. Earnings followed suit with Ezz posting a massive half-year loss of EGP 176 million in H1 compared to a profit of EGP 302 million registered a year earlier, further impacted by foreign exchange losses of EGP 61 million compared to previous gains of EGP 99 million in H1 2013. Going forward, we expect Ezz Steel to record a loss of EGP 217 million in 2014 as we believe the company will continue to suffer from increasing production costs and lower capacity utilization for the rest of the year.

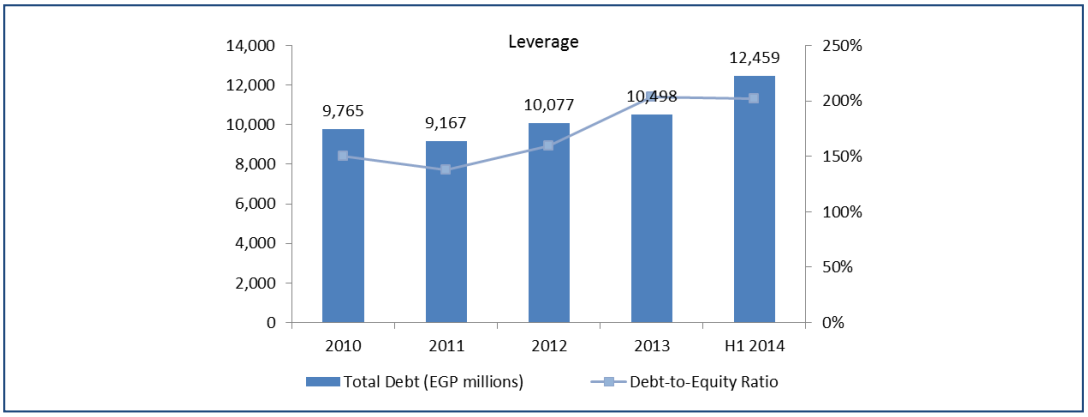


Source: Ezz Steel, Blominvest

Leverage remains at controllable levels

Competing in a capital-intensive industry, Ezz Steel relies heavily on debt to finance its operations. During H1 2014, total debt, including bank overdrafts, surged by 18% from end of 2013 to reach EGP 12.5 billion, sending the total debt-to-equity ratio to 2X compared to 1.6X in 2013. Although the company has a high leverage, we believe Ezz's debt risks are controllable and justified as a significant portion is invested in new projects and future growth.

In details, short-term loans increased by 4% to reach EGP 7.3 billion with available cash covering 45% of bank overdrafts. As for long-term loans, they rose by 46% to EGP 5 billion, leading to a long-term debt-to-equity ratio of 82%, up from 53% at year end. In details, EZDK's debt edged up by 26% from end of 2013 to EGP 3.2 billion, mainly due to financing steel rebars and flat steel activities. Similarly, debt at Al Ezz Flat Steel (EFS) rose by 28% to EGP 1.9 billion to finance the construction of the new direct-reduced iron factory at Ein El Sokhna, while debt at Ezz Rolling Mills (ERM) climbed by 19% to EGP 1.9 billion to finance activities at the DRI factory. Collaterals for the loans are mainly real estate mortgages and commercial pledge on the land, as well as tangible and intangible assets of the company.



Source: Ezz Steel

QUARTERLY INCOME STATEMENT

In EGP million	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14	Q2'14
Net sales	5,581	5,561	4,840	5,313	5,287	4,977
Cost of goods sold	(4,821)	(4,899)	(4,414)	(4,830)	(4,915)	(4,751)
Gross Profit	**760**	**662**	**426**	**483**	**372**	**226**
Selling & marketing Exp.	(32)	(44)	(33)	(35)	(31)	(37)
General & Admin. Expenses	(117)	(129)	(151)	(164)	(128)	(157)
Impairment Loss on Assets	(0)	-	(7)	-	-	(0)
Provisions	(7)	(1)	(1)	(0)	-	-
Total expenses	**(157)**	**(174)**	**(192)**	**(199)**	**(159)**	(194)
Finance expenses	(236)	(216)	(207)	(204)	(184)	(208)
Interest income	18	24	28	29	26	23
Other income	115	61	(16)	(20)	(23)	(11)
Total other expenses	**(104)**	**(131)**	**(195)**	**(195)**	**(181)**	**(196)**
Net profit before tax & non-controlling interest	**499**	**358**	**39**	**89**	**33**	**(164)**
Income tax expense	(115)	(129)	(95)	(62)	(78)	(25)
Deferred tax expense	(13)	21	27	(87)	65	27
Net profit before minority interests	**372**	**250**	**(29)**	**(60)**	**(20)**	**(163)**
Minority interest	(169)	(151)	(55)	241	(39)	6
Net profit after minority interests	**202**	**99**	**(84)**	**181**	**(19)**	**(157)**

Source: Ezz Steel

PROJECTED INCOME STATEMENT

In EGP million	2011	2012	2013	2014e
Net sales	18,611	19,799	21,294	19,569
Cost of goods sold	(16,404)	(18,109)	(18,963)	(18,395)
Gross Profit	**2,207**	**1,690**	**2,331**	**1,174**
Selling & marketing Exp.	(113)	(102)	(145)	(127)
General & Admin. Expenses	(297)	(373)	(561)	(548)
Impairment Loss on Assets	(17)	(4)	(7)	-
Provisions	(81)	(2)	(9)	-
Total expenses	**(509)**	**(480)**	**(721)**	**(675)**
Finance expenses	(764)	(880)	(862)	(747)
Interest income	64	42	98	92
Other income	30	148	140	(55)
Total other expenses	**(670)**	**(690)**	**(624)**	**(710)**
Net profit before tax & non-controlling interest	**1,028**	**520**	**985**	**(211)**
Income tax expense	(359)	(275)	(401)	(63)
Deferred tax expense	(133)	5	(51)	100
Net profit before minority interests	**536**	**250**	**(137)**	**(174)**
Minority interest	(334)	(242)	(134)	(43)
Net profit after minority interests	**202**	**8**	**398**	**(217)**

Source: Ezz Steel, Blominvest

BALANCE SHEET

In EGP million	2011	2012	2013	H1 2014
Non-current Assets				
Property, plant & equipment	9,937	11,127	11,287	11,238
Projects under construction	3,558	2,755	3,178	3,673
Goodwill	315	315	315	315
Other non-current assets	281	304	313	330
Total non-current assets	14,090	14,500	15,093	15,556
Current Assets				
Inventories	3,629	3,620	3,225	4,378
Trade & notes receivable	122	52	167	201
Debtors & other debit balances	628	924	1,108	1,240
Advances to suppliers	135	59	68	52
Investments in treasury bills	63	47	43	40
Cash & cash equivalents	1,171	1,290	2,154	1,378
Total current assets	5,747	5,991	6,766	7,290
Total Assets	19,837	20,492	21,859	22,845
Non-current Liabilities				
Loans	3,937	3,377	3,427	4,994
Other non-current liabilities	667	779	893	543
Bonds loan	433	216	-	-
Deferred tax liabilities	790	789	839	748
Total Non - current liabilities	5,828	5,161	5,159	6,285
Current Liabilities				
Banks credit accts & Overdrafts	1,003	2,061	2,852	3,034
ST Loans & Borrowings	3,573	4,203	3,782	4,318
Bonds loan	220	220	438	-
Trade & notes payable	1,364	1,413	1,688	1,585
Advances from customers	236	287	267	315
Creditors & other credit balances	389	359	494	775
Income Tax	359	275	401	103
Liability of the supplementary pension scheme	-	-	1	2
Provisions	204	205	197	197
ST portion of LTD	-	-	56	112
Total Current Liabilities	7,349	9,023	10,176	10,444
Total Liabilities	13,177	14,184	15,335	16,728
Shareholders' Equity	6,661	6,307	6,524	6,117
Total Liabilities & Equity	19,837	20,492	21,859	22,845

Source: Ezz Steel

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Equity Rating Key

Recommendations are based on the upside (downside) between our 12-month Fair Value estimate and the current Market Price.

Buy: Fair Value higher than Market Price by at least 20%
Accumulate: Fair Value higher than Market Price by 10% to 20%
Hold: Fair Value ranges between -5% to +10% in relation to Market Price
Reduce: Fair Value lower than Market Price by 5% to 15%
Sell: Fair Value lower than Market Price by at least 15%

Risks are based on share price volatility along with qualitative factors such as the nature of the business, the country risk and sensitivity to a single event, single product or single buyer. We've arranged the risk factor into 5 trenches:

- High Risk
- Medium-to-High Risk
- Medium Risk (similar to Market Risk)
- Medium-to-Low Risk
- Low Risk

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