Ezz Steel

بلوم مصر لتداول الأوراق المالي
BLOM EGYPT SECURITIES

BLOMINVEST BANK

Alert on 2010 Earnings Report

Sector:	Basic Materials & Industrial Products
Country:	Egypt
Date:	September 5, 2011

Share Price (EGP):	8.79
Fair Value (EGP):	9.50
Upside:	8.08%
Recommendation:	Hold

Updating with a HOLD recommendation and a fair value of EGP 9.50 to account for revised forecast

Top line exceeds our estimates on improved capacity utilization

Ezz Steel reported revenues at EGP 16,621 million for 2010, rising 32% y-o-y on increased sales volumes led by a noticeable improvement in capacity utilization. This exceeds our estimates of EGP 14,586 million as the domestic demand expanded on the flourishing residential market exhausting the 4% y-o-y increase in long steel output. Flat steel sales witnessed a 28% y-o-y hike on demand recovery from export markets, marked by the 49% y-o-y jump in flat output with the full return to operation at EFS plant during H2 2010.

Earnings before taxes met our estimates on pressured margins

Net income grew almost threefold to EGP 252 million in 2010 from EGP 88 million the year before as revenues increased faster than expenses. Earnings before taxes were in line with our estimates as the spike in commodity prices during Q4 2010 weighed on the company's gross margin down to 11.6%, from 14.6% in H1 2010, despite revenues growing above expectations. In addition, higher-than-expected financing costs on increased borrowings further reduced margins. Operating margin on the other hand witnessed a small improvement to 9.2% from 8.4% in 2009, on higher operating efficiency.

Liquidity drops on further liabilities related to DRI expansion

Ezz Steel witnessed a drop in liquidity levels as the company increased borrowings substantially to finance the progress of EZDK's DRI expansion project. The current portion of its long term borrowings doubled sending total current liabilities to EGP 6,988 million up by 35% y-o-y. The liquidity drop was further affirmed by the smaller y-o-y rise in current assets edging up by 16% y-o-y to EGP 6,057 million. This was due to the 39% y-o-y jump in inventory levels to EGP 3,734 million on increased production activity at Ezz Steel's plants. In this context, the net working capital fell to minus 0.15 while the current ratio fell to 0.87, down from 1.01 in 2009.

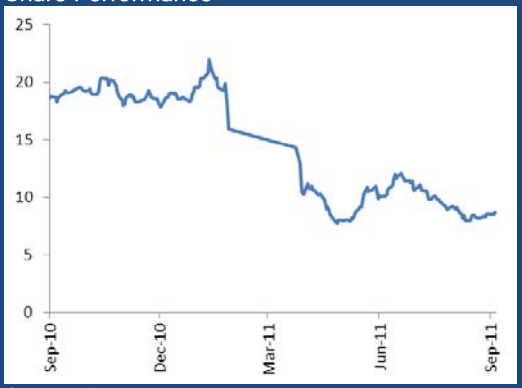
Fair Value Lowered on uncertainty surrounding business setting

With the slowdown in Egypt's construction sector during the first few months of the year coupled with the absence of new contract awards amidst the uncertainty surrounding the investment environment and the upcoming presidential elections in September, we lower our target price to EGP 9.50 from EGP 14.22 previously. We update our recommendation to HOLD with a discount rate at 17% and a 4% terminal growth. This is further supported by the probability of a split between EZDK and Ezz Steel on the possible verdict of a breach to Egypt's competition law.

Share Data

Bloomberg Symbol	ESRS.EY
Reuters Symbol	ESRS.CA
Market Cap (EGP)	4,775,299,587
Number of Shares	543,265,027
Free Float	35%
Price-to-Earnings 10	19.00
Price-to-Book 10	0.77

Share Performance



Source: Reuters

1 Month Return	-4.70%
3 Month Return	-14.36%
6 Month Return	-18.67%
12 Month Return	-53.37%
52 Week Range	21.96 – 7.76

Source: Reuters

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Performance and Forecasts

Year	2009	2010	2011e	2012f	2013f	2014f
Revenues (EGP M)	12,589	16,621	15,633	17,494	19,752	22,130
Net Income (EGP M)	88	251	124	314	415	503
EPS (EGP)	0.16	0.46	0.23	0.58	0.76	0.93
BVPS (EGP)	10.97	11.36	10.24	12.97	15.68	12.55
ROA	0.5%	1.4%	0.7%	1.7%	2.1%	2.6%
ROE	1.3%	3.9%	2.0%	4.7%	5.1%	6.3%

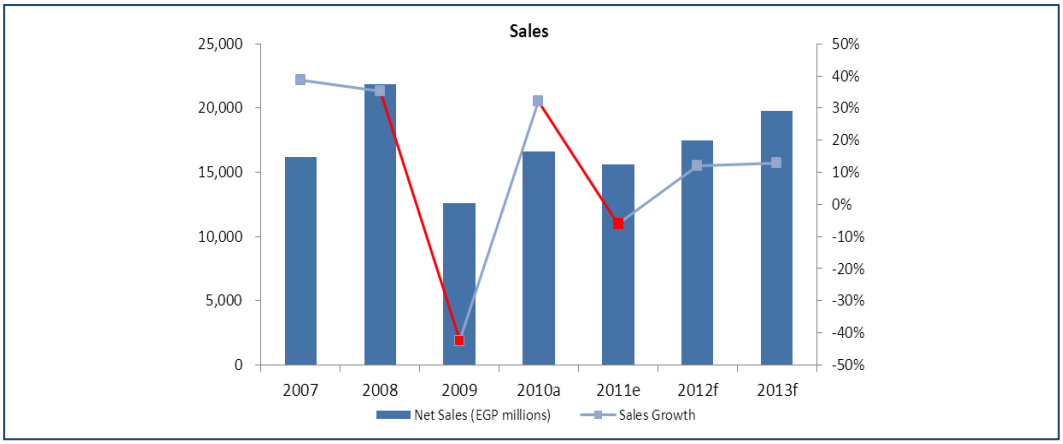
Source: Reuters, Blominvest

INCOME STATEMENT HIGHLIGHTS

Revenues

Revenues at Ezz Steel witnessed a 32% y-o-y surge in 2010 to EGP 16,621 million, rebounding from the Great Recession that had sent the top line down by 42% y-o-y in 2009, yet were short of the pre-recession level of EGP 21,843 million. Sales growth was led by a record increase in annual production volumes boosted by the return to full operation at EFS plant during the second half of the year after production of flat steel used primarily in manufacturing has been frozen amidst feeble demand from export markets. Total flat output at Ezz Steel jumped by 49% y-o-y to 1,461 thousand tons and long output increased by 4% y-o-y to 3,411 thousand tons.

Sales volume of long steel used in construction and infrastructure projects rose by 4% y-o-y to 3,393 thousand tons on strong domestic demand which contributed to 98% of the product's sale in 2010, and in line with the year before. Flat steel sales volume on the other hand jumped by 28% y-o-y to 1,305 thousand tons as worldwide industrial manufacturing picked up and factories expanded upon the global economic recovery.



Source: Ezz Steel, Blominvest

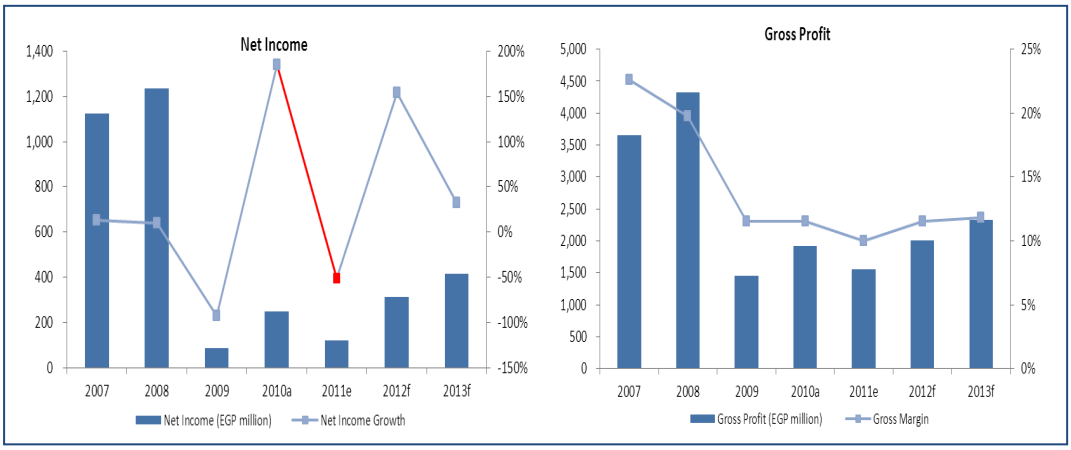
Local sales constituted around 80% of The Egyptian steel maker's top line for the year, the same levels recorded in 2009, while the remaining 20% was mostly attributed to export markets led by Europe and the MENA region.

Earnings and margins

The performance of Ezz Steel improved during 2010 as gross profit reached EGP 1,923 million, 6% below our estimates, growing at the same pace of that of revenues, on increased sales volumes. The gross margin remained unchanged y-o-y at 11.6%, yet was lower than the 14.6% recorded during the first half-year as the increase in local price was unable to catch up with the unexpected surge in steel prices globally during the last quarter of 2010.

Ezz Steel's operating margin improved to 9.2% from 8.4% in 2009 on improved efficiency in operating expenses which averaged 1.2% of the steel maker's top line in 2010 compared with 1.6% the year before.

Earnings before taxes and minority interest on the other hand, were in line with our expectations at EGP 772 million and up by 55% from last year's results, as the spike in commodity prices during Q4 2010 weighed on the company's gross margin despite revenues growing above expectations. Finally, net income witnessed an almost threefold jump to EGP 252 million from EGP 88 million in 2009 as revenues grew faster than expenses and borrowing costs.



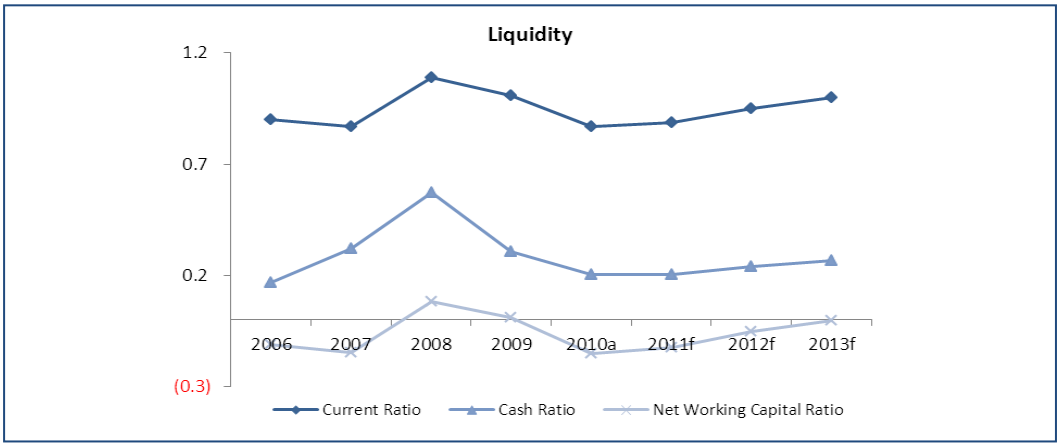
Source: Ezz Steel, Blominvest

BALANCE SHEET HIGHLIGHTS

Liquidity

In 2010, Ezz Steel witnessed a drop in liquidity weighed down by a hike in current liabilities largely offsetting the 16% y-o-y increase in current assets to EGP 6,057 million and resulting in a net current liability position of EGP 931 million. The 39% y-o-y gain in inventories to EGP 3,734 million on resumed production didn't keep pace with short term borrowings which doubled during the year to EGP 3,292, sending the net working capital ratio to minus 0.15. The current, quick and cash ratios fell to 0.87, 0.3 and 0.2 respectively, down from 1.01, 0.5 and 0.31 during the previous financial reporting period.

Current Ratio = Current Assets / Current Liabilities
Cash Ratio = Cash / Current Liabilities
Net Working Capital Ratio = (Current Assets – Current Liabilities) / Current Assets



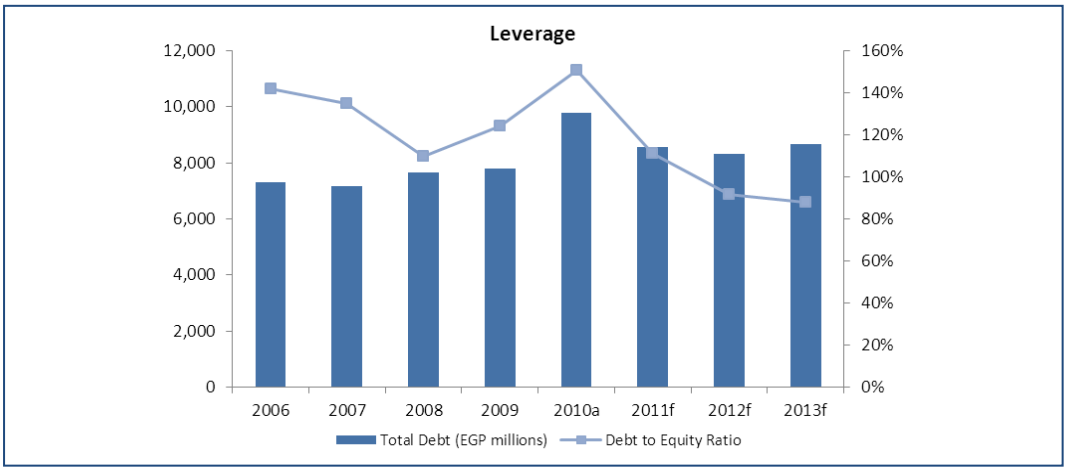
Source: Ezz Steel, Blominvest

Dividend payment

Ezz Steel does not have a specific dividend distribution policy. Normally, the company distributes dividends when it is not investing in the expansion of its operations. The company paid no dividends on the 2009 and 2008 earnings and we expect no dividend payout for the current year on the challenging liquidity levels and the company's ongoing plan to expand its DRI output.

Financial Leverage

Total debt to the steel maker including bank overdrafts and bond loans reached EGP 9,765 million, a 25% y-o-y surge sending the total debt to equity ratio to its highest levels in five years at 151%, up from 124% in 2009. During 2010, Ezz Steel increased its loans and borrowings by almost 50% to EGP 7,758 million to finance the construction of the new DRI project. The gearing ratio – which measures a company's long-term debt to equity – stood at 79% last year up from 71% the year before.

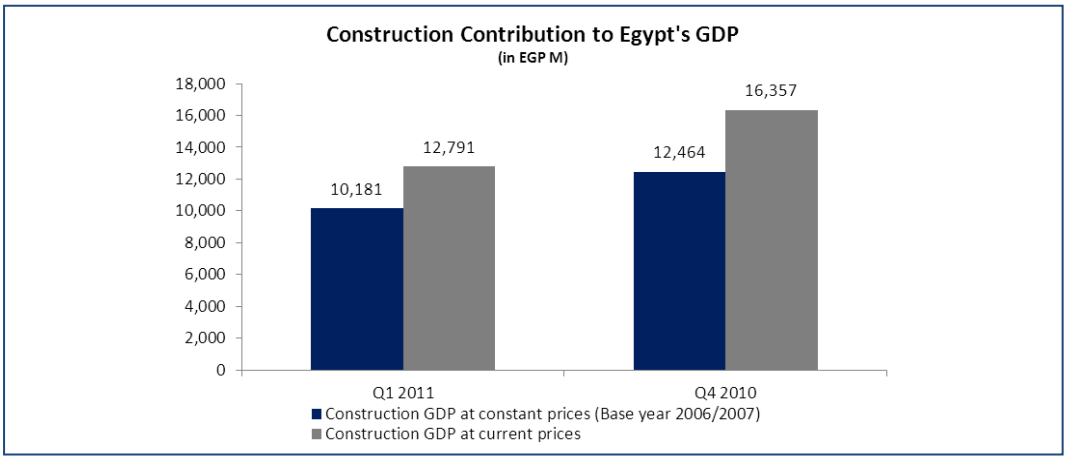


Source: Ezz Steel, Blominvest

Outlook

Political turmoil weighs on Egypt's buoyed construction sector

The construction boom that braced Egypt's economic growth through the global downturn has stalled amid political woes since the ousting of President Mubarak, and the interior government is holding grip on funds for infrastructure projects at the wake of the presidential elections. Uncertainty about the future and depressed public confidence in property companies dragged by corruption investigations pressured on real estate sales and put on hold luxury residential and tourism developments that were keeping the construction industry afloat. The slowdown in demand cut business for many small to medium suppliers to the sector and sources of funding to property developers have now dried up as banks are currently unwilling to provide capital to developers whose integrity is under question.

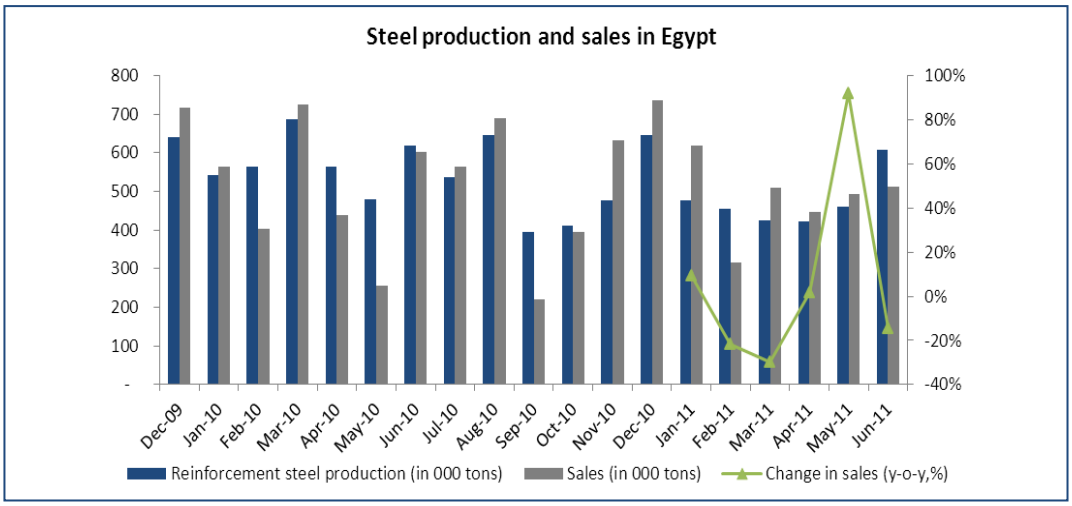


Source: Ministry of Economic Development, Blominvest

The infrastructure industry's outlook is challenged by the absence of the new contract awards

The Infrastructure projects pipeline slackened as the public sector is not in a position to award contracts until liquidity improves and some semblance of political stability returns, which we believe will not happen any time before early 2012. We, therefore, expect a slight brake on any potential growth in the construction sector in Egypt except for projects supported by international funding.

Despite the lack of new contract awards, the sector is still seeing some activity owing to contracts awarded before the uprising in January. Since April, construction activity seems to have started to pick up as reinforcement steel sales volume in Egypt have witnessed a recent upsurge compared to the same period in 2010. During the second quarter of 2011, steel sales gained 12% y-o-y to 1,454 thousand tons, rebounding from a 14.8% y-o-y plunge a quarter earlier at 1,442 thousand tons. In this context, we believe that the construction activity will expand during 2011, until early 2012 when the lack of progress in the infrastructure projects pipeline starts to weigh on the sector's growth due to reduced newly awarded contracts since the beginning of the year.



Source: IDSC, Blominvest

The residential sector remains the growth driver amidst Egypt's political woes

On the residential sector in Egypt, the market is suffering from a low-income housing shortage estimated at around 360,000 units according to Reuters, amidst strong population fundamentals coupled with a high rate of marriages and an urbanization rate of 2% per year. This has pushed the government to undertake major urban planning programs in 2005, the National Housing Project, aimed at easing the country's low-income housing deficit. Under the program, the government sells land to developers at discounted prices for the construction of 500,000 units of housing out of which 235,000 were built and delivered by end 2009 while 190,000 units were under construction. It was announced in March 2011 that Haram City, one of the program's projects, will deliver its next phase on schedule and is estimated to contain a total of around 70,000 residential units.

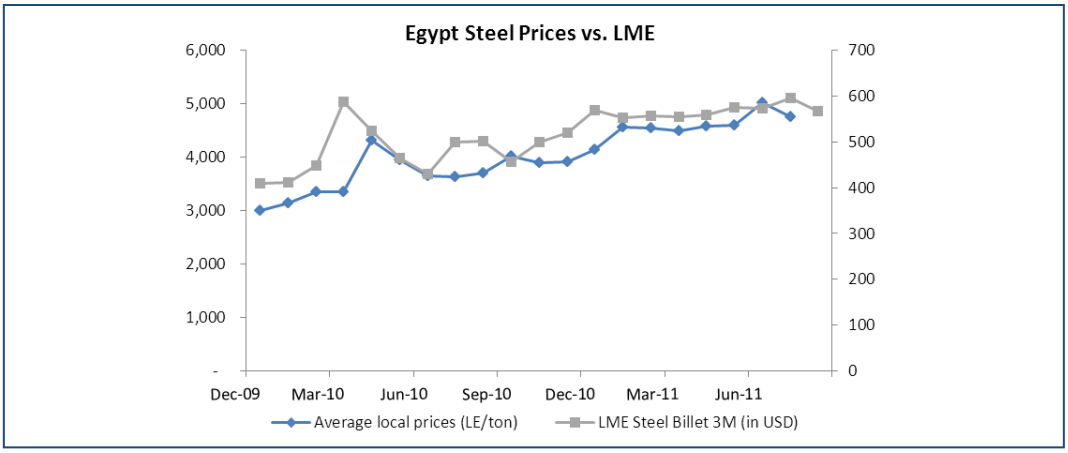
Furthermore, Egypt's large and continuously expanding middle-class population will continue to be a major driver of growth within the sector amidst a depressed demand for luxury residential units, especially as this tranche of the population seeks to escape the country's polluted and overcrowded cities to more suburban areas.

In this context, we hold a positive medium to long-term view of the construction sector, although we see a short-term slowdown for infrastructure, tourism and luxury residential developments on current hibernation in new awards and in projects pipeline as we believe that this freeze is only temporary and Egypt has the fundamentals to drive the sector's growth once the political situation in the country stabilizes, by early 2012.

Anticipating a slowdown in Ezz Steel's top line in 2011

We expect a 10.4% y-o-y drop in total steel sales volume for 2011 at Ezz Steel to 4,191 thousand tons for both long and flat products on the political instability and the uprisings that have stalled most construction activity in Egypt's major cities during the first few months of the year. This is further supported by political woes in some of the countries in the MENA region which contributes to around 25% of export sales, or around 5% of Ezz Steel's total revenues.

We however forecast a smaller decline in the top line by around 5.9% y-o-y to EGP 15,633 million on surging local steel prices during the first half of 2011, which seem to follow trend with the LME.



Source: IDSC, Blominvest

Yet, the dampened local demand on concerns regarding the presidential elections and the outcomes of Mubarak's trial, coupled with the uncertainty of the global economy and the subsequent massive fluctuations in financial markets over the past few weeks have pushed domestic steel prices down by 7% m-o-m in July, a situation we believe will persist at least until the presidential elections in September.

On earnings outlook, we anticipate a decline in Ezz Steel's gross margin to 10% from 11.6% in 2010, as the feeble local demand for steel will weigh on the price's upside potential. The operating and net profit margins are also expected to decline to 7.4% and 0.8% respectively, down from 9.2% and 1.5% in 2010.

Weaker anticipated sales for the year will push the steel maker's net profit down by around 51% y-o-y EGP 124 million.

Issuing a HOLD recommendation on Ezz Steel's stock with a fair value of EGP 9.50

We issue a HOLD recommendation on the stock and revise our target price down to EGP 9.50 with a discount rate of 17% and a terminal growth of 4%, supporting investors' lost confidence in the management of Ezz Steel and delayed DRI expansion project. In fact, the banking system has been holding tight grip on funds for Ezz Steel recently granting the company one loan out of the three requested since the beginning of the year.

Our views are based on the assumption that no split will occur between Ezz Steel and EZDK as there is no credible support that the venture breached any competition law to date, although it is highly likely that the question will be raised by the government once the situation in Egypt stabilizes.

PROJECTED INCOME STATEMENT

In EGP million	2009	2010a	2011e	2012f	2013f	2014f
Net sales	12,589	16,621	15,633	17,494	19,752	22,130
Cost of goods sold	(11.135)	(14,698)	(14,070)	(15,482)	(17,421)	(19,474)
Gross Profit	1,455	1,923	1,563	2,012	2,331	2,656
Selling & marketing expenses	(128)	(154)	(188)	(227)	(277)	(266)
General & admin. Expenses	(274)	(235)	(219)	(245)	(237)	(288)
Impairment loss on assets	(5)	(2)	-	-	-	-
Provisions	(15)	(95)	(100)	(75)	-	-
Total expenses	(422)	(486)	(506)	(547)	(514)	(553)
Finance expenses	(779)	(754)	(830)	(731)	(741)	(723)
Interest income	89	67	103	117	108	107
Other income	154	22	20	20	20	20
Total other expenses	(536)	(665)	(708)	(594)	(613)	(596)
Net profit before tax & non-controlling interest	497	772	349	871	1,204	1,506
Income tax expense	(141)	(171)	(70)	(174)	(277)	(361)
Deferred tax expense	(49)	(37)	(27)	(28)	(25)	(27)
Net profit before minority interests	307	564	252	668	902	1,118
Minority interest	(219)	(313)	(129)	(354)	(487)	(615)
Net profit after minority interests	88	251	124	314	415	503

Source: Ezz Steel, Blominvest

PROJECTED BALANCE SHEET

In EGP million	2009	2010e	2011f	2012f	2013f	2014f
Non-current Assets						
Property, plant & equipment	9,627	9,567	9,051	9,041	9,235	9,407
Projects under construction	1,427	3,319	3,088	3,319	4,244	1,931
Goodwill	315	315	315	315	315	315
Other non-current assets	25	198	7	6	8	5
Total non-current assets	11,393	13,399	12,461	12,681	13,803	11,658
Current Assets						
Inventories	2,679	3,734	3,205	3,324	3,457	3,541
Trade & notes receivable	112	185	172	227	296	288
Debtors & other debit balances	694	617	517	560	593	664
Advances to suppliers	132	48	188	175	217	221
Investments in treasury bills	11	58	380	380	380	380
Cash & cash equivalents	1,581	1,415	1,329	1,574	1,778	1,992
Total current assets	5,208	6,057	5,791	6,240	6,720	7,085
Total Assets	16,601	19,455	18,251	18,922	20,524	18,744
Non-current Liabilities						
Loans	3,547	4,466	3,940	3,561	3,310	2,921
Other non-current liabilities	114	205	225	246	271	299
Bonds loan	880	651	431	211	-	-
deferred tax liabilities	621	658	717	783	862	939
Total Non - current liabilities	5,162	5,980	5,313	4,801	4,443	4,159
Current Liabilities						
Banks credit accts & Overdrafts	1,498	1,136	1,337	1,393	1,603	1,753
ST Loans & Borrowings	1,654	3,292	3,095	2,477	2,439	2,337
Bonds loan	220	220	220	220	220	220
Trade & notes payable	860	1,145	957	1,006	1,080	1,149
Advances from customers	365	410	610	700	770	775
Creditors & other credit balances	531	662	802	913	1,080	1,168
Provisions	38	123	43	52	53	50
Total Current Liabilities	5,165	6,988	7,063	6,762	7,245	7,452
Total Liabilities	10,327	12,968	12,376	11,563	11,688	11,611
Shareholders' Equity	6,274	6,487	5,876	7,359	8,836	7,133
Total Liabilities & Shareholders' Equity	16,601	19,455	18,251	18,922	20,524	18,744

Source: Ezz Steel, Blominvest

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Equity Rating Key

Buy: A recommendation with a potential return greater than 10% based on our current 12-month view of total shareholder return*.

Hold: A recommendation with a potential return between -10% and 10% based on our current 12-month view of total shareholder return.

Sell: A recommendation with a potential return of less than -10% based on our current 12-month view of total shareholder return.

* Total Shareholder Return is calculated by the potential price growth over a 12-month period along with the expected dividend yield.

IMPORTANT DISCLAIMER