Ezz Steel

بلوم مصر لتداول الأوراق المالي
BLOM EGYPT SECURITIES

BLOMINVEST BANK

Update on H1 2015 Earnings

Sector: Basic Materials & Industrial Products

Country: Egypt

Date: November 27, 2015

Current Share Price: EGP 8.40

Target Price: EGP 7.45

Upside/ Downside: -11%

Recommendation: SELL

Downgrading Ezz Steel to a SELL rating on continuing losses and weak prospects

Ezz Steel released its consolidated financials for H1 2015 showing additional losses for the fifth quarter running.

Lower revenues and higher costs distress net profit:

The company struggled with Egypt's energy crisis, considering that natural gas is a major raw material for the production of steel in Direct-Reduced (DRI) plants. The company's utilization rates remained low and with the prevailing low prices for steel, the company's revenues shrunk by 9.84% in H1 to EGP 9.25billion. *We estimate sales to finish 2015 at EGP 18,464 million taking into consideration the persistent low prices of steel as shown by Bloomberg consensus forecasts, and the continuing lack of natural gas during H2 which is needed to operate the group's DRI factories.*

Gross profit was further pressured in H1 by the lift of subsidies on energy in Egypt, as well as the group's reliance on more expensive raw materials. This squeezed Ezz Steel's gross margin from 5.83% in H1 2014 to 4.67% in H1 2015, leading gross profit downward by 27.74% to EGP 432 million. *We don't expect an improvement in margins in H2 2015, neither in 2016 outside an unlikely rise in steel prices.*

Ezz's consolidated net income excluding minority interest therefore recorded a loss of EGP 337.06 million for H1 2015, almost double the loss of H1 2014 which recorded EGP 337.06 million. *We expect 2015 to finish with a loss of EGP 763 million, especially due to the small margins but moreso due to the high financing costs, although we accounted in our model for the rescheduled debt.*

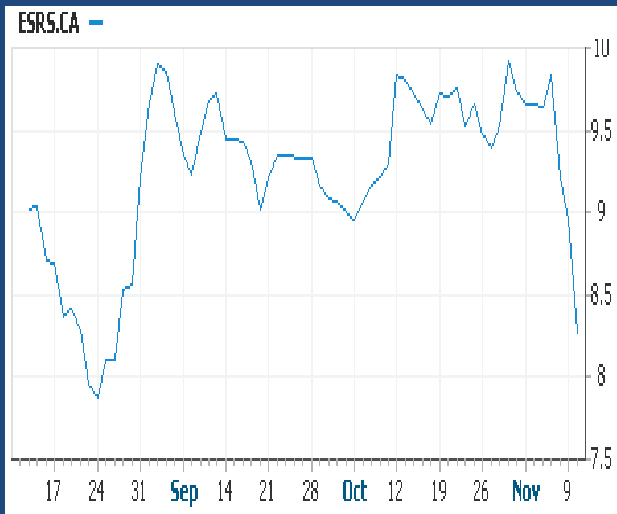
Excessive reliance on debt burdens the company's profits:

The group's high leverage continues to drag on operations. With a total net debt of EGP 13 billion and despite the latest rescheduling of EGP 1.7 billion into a longer term loan, interest expenses remain very high totaling EGP 559 million in H1 2015 and eating away the already small profits. Ezz' net debt to equity ratio rose from 1.78 times in H1 2014 to 2.68 times in H1 2015.

Share Data

Bloomberg Symbol	ESRS EY
Reuters Symbol	ESRS.CA
Market Cap (M. EGP)	4,552.6
Number of Shares	543,265,027
Free Float	35.42%
EV/EBITDA	46.02

Share Performance



Source: Reuters

1 Month Return	-10.64%
3 Month Return	-1.52%
6 Month Return	-27.96%
12 Month Return	-50.62%
52 Week Range	7.22- 17.15

Source: Reuters

Contact Information:
Research Assistant: Sandra Said
sandra.said@blominvestbank.com

Head of Equities: Maya Mantach, CFA
maya.mantach@blominvestbank.com

Head of Research: Marwan Mikhael
marwan.mikhael@blominvestbank.com

Performance and Forecasts

In EGP millions	2012	2013	2014	2015e
Revenues	19,799	21,294	19,398	18,464
Gross Profit	1,690	2,331	691	739
Gross Profit Margin %	8.54%	10.94%	3.56%	4.00%
Net Income	8.38	129.62	(696)	(763)
Net Profit Margin %	0.04%	0.60%	(3.59)%	(4.13)%

Source: Ezz Steel, Blominvest

Recommendation:

We downgrade our rating on Ezz Steel from HOLD to SELL with a target price of EGP 7.45, as we don't see the recovery of the company's operational performance in the near term, or at least without some drastic measures that could incite positive cash flows into the company. Our valuation is based on both the DCF model and a relative valuation through the multiple EV/EBITDA. Both models are yielding large downside potentials for the company at its current status.

Although EZZ Steel remains one of the largest supplier of steel in the Egyptian market with a 50% market share and little competition given its large production capacity, and despite his large assets of over EGP 20 billion, we believe that the group's operating performance is under a lot of stress and will not recover in the coming months.

Our recommendation is based on two aspects:

On the group-specific level, we believe that Ezz steel will continue to suffer from losses in the coming year, especially in light of:

(1) international low prices of steel reducing revenues and despite the artificial floor prevailing in Egypt,
(2) the structural shift in the group's cost structure after the lift of subsidies even in the context of low oil prices (the price of natural gas for Iron and Steel industry moved from $ 3/mbtu to $7/million mbtu),
(3) the inability of the factories to reach previous utilization rates as the country's gas problems persist,
(4) the high financing costs which will continue to reverse profits made from operations,
(5) the group hasn't been able to pay dividends for the past 4 years, and as we expect more losses down the way we doubt shareholders can expect dividends anytime soon.

On the industry level, we believe it will sustain more pressure in the near term, due to:

1) the restricted access to foreign currency knowing that the group's main production consisting of long steel (81% of sales in H1 2015) is consumed domestically and not exported to bring back foreign currency,
2) the impact of lack of natural gas in the nation on the group\s recently opened DRI factory,
3) the currency devaluation hurts importing industries, which has the double effect of protecting Ezz Steel from imported steel but at the same time increasing its imported raw material costs.

We will reconsider our valuation in light of a positive event such as:

1) The group's access to gas improves, in which case the utilization rates of the DRI factories will substantially improve.
2) The industry receives governmental support,
3) The group substantially controls down its leverage,
4) FX shortage problem in Egypt is resolved,
5) Group cuts down its loss making lines and related expenses.

Financial Highlights

Ezz Revenues Drag on the Back of Energy Shortages, Despite Fall in Iron Ore Price:

Ezz Steel registered a poor performance in H1 2015 compared to the same period last year especially in terms of production volume. Total production fell by 13.33% from H1 2014 to 2.03 million tons in the same period this year. In details, the production of long and flat steel fell by 12.93% and 14.99% to 1.64 million tons and 384,118 tons in H1 2015, respectively.

Consolidated revenues dropped by 9.84% to reach EGP 9.25 billion in H1 2015 compared to EGP 10.26 billion in the same period last year. The company continues to suffer from the rise in the price of natural gas, a decision implemented by the government last year, raising the price from $3 to $7 per one million thermal units for iron, steel and other metal companies. However, it is worth mentioning that the company has been implementing new production methods that are less costly. In Ezz Steel Group, steel is produced in two different ways; the first is through the imported high-grade scrap metal, and the second method through the production in DRI plants which operates on natural gas, noting the first is much more expensive than the second. Despite the global decrease in iron ore price (which benefit the production through DRI factories, the continuous lack of natural gas necessary for these plants in Egypt deprived the company from benefitting from that luxury.

In terms of pricing, and compared to H1 2014, the steel prices of the products sold on the domestic market declined by 3% for the long and by 5% for the flat. As for the exported steel, it followed the international trend with both long and flat products prices declining by 17%. It is worth mentioning that the 98% and 68% of long and flat steel, respectively, are sold domestically while the remaining percentages are exported.

In terms of Selling, General and Administrative expenses (SG&A), they increased by 26.48% from EGP 335 million in H1 2014 to EGP 424 million in H1 2015. We expect the company to bear additional higher SG&A expenses as a result of the new DRI plant which is expected to raise 1,000 new job opportunities.

Valuation

Our DCF valuation is based on rather stable selling prices for steel, given that domestic prices are resistant to downside adjustment at the current time. However, we don’t see this scenario sustainable in the near future, as imports will become more attractive even with the current imports’ tax of 8%. Moreover, steel prices are forecasted to slightly pick up in 2016 but will atay aligned to their current trends in the medium term.

We also included an increased utilization in our forecasts, coming from the increased available capacity for the group, thereby estimating production volumes to reach 5.5 million tons in 2016 and 6.1 million in 2016.

Regarding gross margin, we assumed it will remain between 4% and 5% in the coming 3 years, and increased SG&A to account for the new employment needed to operate the new factory.

These baseline assumptions cover a forecasted period of 5 years, and have led to subdued EBITDAs, unlikely to sustain the company's working capital needs and financing obligations. This leads us to believe that at the current price levels and production obstacles, operations will continue to suffer unless drastic measures are taken.

As for our target price, it was reached based on the company expected EBITDAs in the next 5 years, and a global EV/EBITDA of 8.6x.

Relative Valuation

Steel Production Sector in Egypt

Ticker	Name	YTD% Return	EV/EBITDA	Market Cap (Millions USD)
ESRS EY	Ezz Steel	-48.40%	46.02	581.42
Egyptian Iron and Steel Company	IRON EY	-49.27%	NA	217.70
Misr National Steel Company	ATQA EY	-37.47%	NA	33.18

Date: November 19, 2015. Source: Bloomberg

Selected Steel Producing Companies in the MENA:

Name	Country	YTD% Return	EV/EBITDA	Market Cap (Millions UD)
Weighted Average*			***5.69***	
Ezz Steel	Egypt	-48.40%	46.02	581.42
Zamil Industrial	Saudi Arabia	-17.47%	8.72	598.99
Saudi Steel Pipe Company	Saudi Arabia	-6.89%	14.95	294.01
United Wire Factory	Saudi Arabia	-30.74%	12.45	268.14

Date: November 19, 2015. Source: Bloomberg, Zawya

= weight is based on market capitalization of each company out of the total market capitalization.

Selected Half Year- Income Statement

Income Statement *(in LE millions)*	***H1 2014***	***H1 2015***
Net Sales	10,264	9,254
COGS	(9,666)	(8,821)
Gross Profit	**598**	**432**
Selling & Marketing expenses	(68)	(82)
General & Admin expenses	(267)	(342)
Other expenses	(18)	(24)
Total Operating Expenses	**(353)**	**(418)**
Interest expense	(375)	(559)
Interest income	49	65
Forex differences	(61)	(20)
Other Revenue/Expense	30	17
Net profit before tax & non-controlling interest	**(132)**	**(513)**
Income Tax	103	3
Deferred tax	93	78
Net profit before minority interests	**(143)**	**(438)**
Minority interest	33	(101)
Net profit after minority interests	**(176)**	**(337)**

Source: Ezz Steel

Projected Income Statement

Income Statement *(in LE millions)*	***2013***	***2014***	***2015e***
Net Sales	21,294	19,398	18,464
COGS	(18,963)	(18,707)	(17,726)
Gross Profit	**2,331**	**691**	**739**
Selling & Marketing expenses	(145)	(143)	(185)
General & Admin expenses	(566)	(605)	(609)
Other expenses	(15)	(16)	(2)
Total Operating Expenses	**(726)**	**(764)**	**(796)**
Interest income	98	72	117
Interest Expense	(862)	(881)	(972)
Forex differences	37	(28)	(78)
Other Revenue/Expenses	103	48	17
Net profit before tax & non-controlling interest	**981**	**(862)**	**(973)**
Income Tax	(401)	(42)	0
Deferred tax	(51)	68	20
Net profit before minority interests	**528**	**(836)**	**(953)**
Minority interest	(398)	139	(191)
Net profit after minority interests	**130**	**(696)**	**(762)**

Source: Ezz Steel, Blominvest

Balance Sheet

In EGP million	*2011*	*2012*	*2013*	*2014*	*Q2 2015*
Non-current Assets					
Property, plant & equipment	9,937	11,127	11,287	11,073	11,164
Projects under construction	3,558	2,755	3,178	4,068	4,495
Goodwill	315	315	315	315	315
Other non-current assets	281	304	313	339	376
Total non-current assets	**14,090**	**14,500**	**15,093**	**15,796**	**16,350**
Current Assets					
Inventories	3,629	3,620	3,225	4.093	3,410
Trade & notes receivable	122	52	167	85	48
Debtors & other debit balances	628	924	1,108	1.837	1,914
Advances to suppliers	135	59	68	697	466
Investments in treasury bills	63	47	43	50	28
Cash & cash equivalents	1,171	1,290	2,154	916	2,806
Total current assets	**5,747**	**5,991**	**6,766**	**7,678**	**8,672**
Total Assets	**19,837**	**20,492**	**21,859**	**23,474**	**25,023**
Non-current Liabilities					
Loans	3,937	3,377	3,427	5,894	6,636
Other non-current liabilities	667	779	893	802	818
Bonds loan	433	216	-	-	-
Deferred tax liabilities	790	789	839	773	696
Total Non - current liabilities	**5,828**	**5,161**	**5,159**	**7,469**	**8,149**
Current Liabilities					
Banks credit accts & Overdrafts	1,003	2,061	86	68	18
ST Loans & Borrowings	3,573	4,203	6,547.2	7,534	9,205
Bonds loan	220	220	438	-	-
Trade & notes payable	1,364	1,413	1,688	1,862	1,609
Advances from customers	236	287	267	439	247
Creditors & other credit balances	389	359	532	506	567
Income Tax	359	275	401	42	3
Liability of the supplementary pension scheme	-	-	1	3	3
Provisions	204	205	197	205	205
ST portion of LTD	**-**	**-**	56	112	168
Total Current Liabilities	**7,349**	**9,023**	**10,214**	**10,770**	**12,023**
Shareholders' Equity	**6,661**	**6,307**	**6,486**	**5,235**	**4,849**
Total Liabilities & Equity	**19,837**	**20,492**	**21,859**	**23,474**	**25,023**

Source: Ezz Steel

Regional Stock Markets Performance

Stock Markets	YTD %	Market Cap (in Million USD)
Abu Dhabi	-6.20	116,852.64
Amman	-7.93%	28,492.02
Beirut	-4.03%	11,415.38
Bahrain	-14.87%	5,249.49
Dubai	-14.76%	88,149.95
Egypt	-28.14%	105,332.93
Kuwait	-12.65%	88,987.43
Muscat	-8.58%	23,721.87
Qatar	-12.05%	158,734.03
Saudi Arabia	-16.56%	427,066.72
Tunisia	-2.71%	16,553.17

Date: November 19, 2015. Source: Bloomberg

BLOMINVEST BANK s.a.l.

Research Department
Downtown Beirut, Bab Idriss
Weygand St., Semiramis Bldg.

POBOX 11-1540 Riad El Soloh
Beirut , Lebanon

Tel: +961 1 991784
Blog.blominvestbank.com

For your Queries:

Marwan Mikhael, Head of Research
marwan.mikhael@blominvestbank.com
+961 1 991784 Ext: 319

Maya Mantach, Head of Equities
maya.mantach@blominvestbank.com
+961 1 991784 Ext: 320

Sandra Said, Equity Analyst
sandra.said@blominvestbank.com
+961 1 991784 Ext: 330

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 with qualitative factors such as the nature of the 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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