Results Report

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TA SECURITIES

Bloomberg : MIG MK   KLCI : 1,373.84

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Melewar Industrial Group Bhd

Unearthing Value

Stock Code: MELEWAR (3778)

Price	:	RM 1.52
Target Price	:	RM2.70
Market Capitalisation	:	RM 344.4m
Board	:	Main
Sector	:	Industrial Product
Recommendation	:	BUY

KEY STOCK STATISTICS

		2006*	2007F#
EPS (est.)	(sen)	20.7	21.4
P/E (est.)	(x)	5.7	5.5
Dividend/Share	(sen)	12	
NTA/Share	(RM)	2.96	
Book Value/Share	(RM)	2.74	
Issued Capital	(mil shares)	169.9	
52-weeks Share Price Range	(RM)	1.37/0.86	

Major Shareholders:
- HDM Nominees (Tempatan) S/B (23.29%)
- EPF (14.01%)
- HDM Nominees (Asing) Sdn Bhd (5.11)

PER SHARE DATA

FYE 31 Jan		2004**	2005**	2006**	2007F#	2008F
Book Value	(RM)	2.3	2.2	2.8	3.0	3.2
Cash Flow	(sen)	26.1	15.3	22.2	32.4	38.3
Earnings	(sen)	17.3	20.5	20.7	21.4	25.8
Adjusted Earnings*	(sen)	10.5	20.4	20.7	21.4	25.8
Net Dividend	(sen)	209.6	9.4	3.0	8.0	8.0
Payout Ratio	(%)	1213%	46%	14%	37%	31%
PER	(x)	8.8	7.4	7.3	7.1	5.9
Adjusted PER *	(x)	14.5	7.4	7.3	7.1	5.9
P/Cash Flow	(x)	5.8	9.9	6.9	4.7	4.0
P/Book Value	(x)	0.7	0.7	0.5	0.5	0.5
Dividend Yield	(%)	137.9%	6.2%	2.0%	5.3%	5.3%
ROE	(%)	11%	13%	10%	10%	11%
Net Gearing	(%)	11%	27%	30%	44%	39%

P&L ANALYSIS (RM mil)

FYE 31 Jun		2004**	2005**	2006**	2007F#	2008F
Revenue		462.3	598.7	566.9	779.1	644.2
Operating Profit		83.7	75.6	42.9	85.8	83.1
Depreciation		-15.0	-15.4	-9.0	-15.0	-6.8
Interest Expense		-3.2	-3.0	-8.1	-3.7	-7.1
Pretax Profit		80.6	72.7	35.5	67.1	78.9
Effective Tax Rate	(%)	20%	25%	-16%	28%	26%
Net Profit		64.4	46.5	46.9	48.5	58.4
Adjusted Net Profit *		39.2	46.3	46.9	48.5	58.4
Operating Margin	(%)	18.1%	12.6%	7.6%	9.4%	12.9%
Pre-tax Margin	(%)	17.4%	12.1%	6.3%	8.8%	12.3%
Net Margin	(%)	13.9%	7.8%	8.3%	3.2%	9.1%

*note: * Adjusted for extraordinary gain on sale of investment*
*** FYE Jan*
 # 17 months to June

SHARE PRICE

Source: Bloomberg

The Background

Melewar was incorporated in 1969 under the name Aurora Steel Tube Manufacturing Sdn Bhd. It commenced operation with one production line in 1970 at its factory in Shah Alam with average monthly capacity of 1,000 metric tonnes (mt) of steel tubes. Later, the company was renamed as Maurichi Malaysia Steel Tube Berhad and listed on the main board of Bursa Malaysia Securities in 1986. In 2003, a new name, Melewar Industrial Group Bhd was adopted following a change in major shareholder.

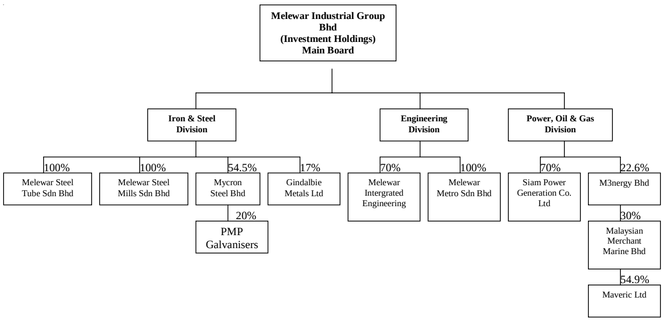
In 1990, Melewar started its first cold-rolling mill in Malaysia under a subsidiary, Mycron Steel Bhd (Mycron), formerly known as Cold Rolling Industry (M) Sdn Bhd. Mycron was listed on the main board of Bursa Malaysia in 2004. The group has also acquired 20% equity stake in PMP Galvanizer, which is actively involved in manufacturing and supplying coil coating, slitting, shearing, roll forming and sheet metal. PMP Galvanizer has committed to purchase 75,000mt of cold rolled coil (CRC) from Mycron every year.

The group has also expanded to the oil and gas industry with the acquisition of M3nergy in Jan 2005, which the group owns 22.6%. M3nergy owns and operates FPSO vessels and is also Malaysia's largest Barite powder manufacturer (Barite is used in oil-well mud). In addition, M3nergy also holds 100% Ujong Kulon offshore oil block in West Java, Indonesia, 30% of Malaysian Merchant Marine Bhd (ship owner and manager) and 53% Maverick Ltd, which is listed in Singapore but is only a shell company with RM74mn cash (after it disposed of its core business).

Earlier in May 2004, Melewar bought a stake in Gindalbie Metals Ltd, a mining company listed on Australian Stock Exchange, which is involved in Iron Ore mining. The latest diversification by the group was in Dec 2005 where the company acquired 70% stake in power plant owner, Siam Power Generation Company Ltd.

In brief, the group is now divided into 3 core businesses namely Iron & Steel, Engineering and Power and Oil & Gas divisions. Table 1 illustrates the group structure:

Table 1 : Corporate Structure



Source: Company

First Task, Dispelling Misconceptions

One of the misconception investors have on Melewar is that it is a pure steel player which has a volatile earnings profile. As highlighted above, the group through concerted efforts has diversified its income stream towards more stable upstream play (iron ore), power income as well as oil and gas sector. Although, most of this new incomes has yet to come on stream (i.e. power division and iron ore) the potentials are definitely worth looking at.

The other misconception that investors have is its Holding Company status. As illustrated in table 2 below, we could see that more than 45% of its revenue is derived from its Melewar Steel Tube and Melewar Steel Mills, a wholly-owned subsidiary while Mycron a 54.5% subsidiary is contributing 32% to the group revenue. So as the subsidiaries are contributing more than 75% of the group's revenue and net profit, we do not believe the holding company status should be attached to Melewar.

Table 2: % Contribution from subsidiary to the Group

	Revenue	PBT	PAT
Steel Tubes	298.5	27.5	23.7
Mycron	212.4	14.9	11.1
Group	652.2	57	46.4
% Contribution of Steel Tube & Mycron to the Group	78.3%	74.4%	75.0%
Steel Tubes	45.8%	48.2%	51.1%
Mycron (54.5% Subsidiary)	32.6%	26.1%	23.9%

Iron and Steel Division - Its Bread & Butter with Exciting Growth

The group's core business would continue to be driven by its iron and steel division. Currently, the bulk of the group's earnings are coming from both from its steel tubes as well as cold rolled coil (CRC), led by Mycron. Admittedly, the group has suffered setbacks in 2006, where the group's iron and steel division was hit by the inventory impairment loss of more than RM30mn in FY06 as a result of sharp fall of Hot Rolled Coil (HRC) price around the world. However, given an improved demand for HRC, price has started to stabilize and the group expects the demand to continue to be strong in the next 3-5 years. Locally demand is expected to improve with the implementation of 9MP. Note that, the steel tube's main customer is from the engineering and construction industry which made up 50% of its total sales while furniture, water supply and auto industries contributed 30%, 15% and 5% respectively.

Based on our discussion with the management, the group's steel tube is running at 50% capacity, an improvement compared to 35-40% a year ago. The group indicates that the higher order might be the results of 9MP but believes it is still small. The group is looking for much better days ahead starting from 2H07 in tandem with our believe that demand will pick up.

Meanwhile, its CRC business should also improve in the near term with stabilizing HRC prices. Mycron is undertaking a capacity expansion to 260,000 tonne per year from the current capacity of 180,000 tonne a year. The good news is that its additional capacity has a ready buyer where PMP Galvanizers (its 20% associate) has signed an off-take agreement with Mycron for 75,000 tonne a year of CRC upon completion of Mycron's upgrade and expansion. The group is looking to complete the project in CY08 and the impact to the bottomline is expected to be in FY09. The management has guided that with the expansion, Mycron would be looking to enhance its net earnings by RM16.6mn or more than 65% of its 3 year average core earnings (adjusted 2006 earnings due to exceptional loss). The higher profitability can be achieved due to the group's ability to produce higher grade CRC products mix following upgrading of its machinery and systems. The group currently is collaborating with JFE Japan (one of Japan's main player in HRC and CRC) to provide technical assistance in producing thin-gauge CRC to penetrate the roofing and auto-industries. A second agreement was signed in January 2007 for JFE to assist Mycron in developing auto-grade CRC for Malaysian car industry.

Importantly, the group has made a bold move in investing upstream activities in buying into a mining company listed in Australian Stock Exchange named Gindalbie Metals Ltd. The group purchased Gindalbie back in May 2004 for AU$0.10 and now the price has reached more than AU$1.20. Based on the announcement by Gindalbie to Australian Stock Exchange on Friday (6 July 2007), the group has report an increase in Karara Megnetite resource to 1.43bn tones grading 36.3 Fe as compared to reserve of 1.29bn announced previously. Based on few reports we read on Australian Iron Ore sector, Midwest Australia where currently Gindalbie's Karara mines are located is becoming an important iron ore region in Australia, with potential similar to the established Pilbara Region. On the back of the envelope calculation, based on simple assumptions of 1)250mn tonne of magnetite over 40 years, 2) Magnetite price of US$55 per tonne, 3) Cost of recovery of USD30/tonne, 4) Capex and Financing 15% of total GPV and 5) discount rate of 15%, we arrived at Net Present Value of RM265mn or RM1.17 per share (Appendix 1). On the other hand, if we take the last closing price of AU$1.20 for Gindalbie, the group should be worth RM266mn or RM1.17 per share. It is important to highlight that our net present value assumptions are very conservative given that the total Magnetite sold throughout the period is only 250mn tonne as compared to the reserve of 1.43bn tonne.

Power and Oil & Gas divisions - Diversification Strategy

The group continues to diversify its income stream investing in the next in-thing, which are the power and oil & gas industries. The group holds 70% stake in Siam Power Generation Compnay Ltd which holds a total licensed capacity of 450MW to built, operate and own power plant in Rayong, Thailand. The group would construct the 1st phase 185MW which is expected to start operation in 2009 and has signed the PPA with EGAT for 25 years, with fuel pass through and index to the US currency. Based on the current fuel price and currency, the average selling price is around US$0.0753/kwh which translates to RM0.26/kwh. Although non-committal, we believe the IRR of the project is above 15%, similar to the first generation PPA signed in Malaysia. Just to illustrate the value of such IPP to investor, we have made a rough calculation to find the value of the power division. Based on a flat US$0.0753/kwh and 180MW capacity for the next 22 years at 90% capacity, the power division would enhance the group's NAV by RM136mn (based on discount rate of 15%) or RM0.60 sen per share (Appendix 2).

Meanwhile, the group exposure to the Oil & Gas Sector will be spearheaded by M3nergy. As we have highlighted before, the group is the owner and operator of FPSO ships. With the oil and gas activities expected to pick-up and more new oil well coming on stream, we expect demand of FPSO to continue to be high. Hence, we could expect to see improvement in M3nergy profitability in FY08 as compared to FY07 earnings. The current rate for FPSO is around RM400,000 a day and expected to increase in the near future due to scarcity of ships and high demand. Note that, both of its FPSO ships contracts expires in 2008 and we could expect higher rates to be charged in the coming contracts.

Engineering Division

Engineering division was what surprises us the most. The management indicates that the group internal engineering and construction arm has close to RM3.3bn worth of outstanding orderbook which derived internally. Table 3 illustrates the contracts in hand for the group's engineering and construction division. Note that, the group has also tendered the Penang Monorail projects. Although the management is optimistic on their success given the competitive pricing, we are less optimistic as we believe Scomi Engineering consortium is the front-runner due to the certain advantages such as having Penang state government body as one of the consortium partners. Even without the Penang Monorail, the group's engineering and construction division is expected to be extremely busy from in-house jobs. Based on the latest quarter result, the group engineering and construction division reported total revenue of RM30mn for 14-months cumulative. Hence, we believe the current orderbook of RM3.3bn is the highest achieved thus far. Assuming the group orderbook is over 6 years, the group would be reporting RM550mn of works per annum. Taking a minimum 1.5% pretax profit margin, the group engineering and construction division is expected to report net earnings of RM6.1mn in FY08.

Table 3: Orderbook

Projects	Value (RMm)
Chip Mill project in Sabah	20.0
Melewar Still Mills Sdn Bhd	80.0
Mycron Steel Bhd Plant upgrade	120.0
M3nergy barite powder plant in Labuan	80.0
Maegma Steel Sdn Bhd Integrated HRC Steel Mill	3,000.0
Total	3,300.0

Grossly Undervalued - Time to BUY

Prior to this we value the company using PER valuation using targeted PER of 7.0x based on 30% discount to industry PE of 9.9x to derived at a fair value of RM1.80. However, we believe the most appropriate valuation is to use sum-of-parts (SOPs) given that the group would be having 3 core businesses namely iron and steel, engineering and construction and power and oil & gas divisions. The other reasons that we are opting to use SOPs valuation is to show the potential of its new divisions namely the Iron Ore mining and power. However, given the new income stream would only come on stream beyond FY08, we have attached a discount of 20% to the group's SOPs valuation to reflect the execution risks, Hence, we derived at a higher fair value of RM2.70 which translate to a reasonable PE multiple of 10.5x based on fully diluted FY08 earnings of 25.8 sen compared to our previous RM1.80.

In addition, the group is committed to payout 50% of its net profit as well as 50% dividend received from listed subsidiaries or associates. Based on our earnings estimates, we are looking for the group to declare a gross DPS of 12 sen in FY08, which translates into a dividend yield of 7.9%. Coupled with the possible capital appreciation of 77.6% from the current price of RM1.52, the group total return exceeds 85.5%. Hence, we maintain our BUY recommendation.

Table 4: Melewar's Sum-of-Parts

	FY08 Net profit (RMm)	12-Month PER (x)	Value (RMm)
Steel	32.8	14.0	459.4
Construction	6.1	10.0	61.4
Associate - Gindalbie (NPV - 15% discount rate)	265.2	0.0	265.2
Associate - M3Nergy	1.5	14.0	21.0
Power - (NPV - 15% discount rate)	135.6		135.6
			942.7
Net asset value (RM'm)			942.7
Borrowings (Company level)			(174.0)
Share cap (m shares) - Fully diluted			227.0
NAV per share (RM)			3.39
20% Discount			0.69
Target Price			2.70
			implied PER 10.5

Appendix 1: Gindalbie's Assumptions & Valuation

Potential 1.43 bn tonne

	Scenario		
Recovery (mn tonne)	250	500	750
Avg Magnetite (USD/tonne)	55	55	55
Gross production value (USDmn)	13,750	27,500	41,250
Cost recovery:			
Operating @ USD30	7,500	15,000	22,500
Capex and Financing @ 15% of GPV (USDmn)	2,063	4,125	6,188
Pretax	4,188	8,375	12,563
Tax @ 35% (USDmn)	1,466	2,931	4,397
Net Attributable to Gindalbie after tax (USDmn)	2,722	5,444	8,166
Melewar's portion @ 17% (USDmn)	463	925	1,388
Initial Investment Outlay (USDmn)	6	6	6
Enhancement (USDmn)	456	919	1,382
NAV @ RM3.50 per USD 1 (RMmn)	1,597	3,217	4,836
NPV 15%, 40 years	265	524	788
NAV per share	1.17	2.31	3.47

Appendix 2: SEPCO's Assumptions and Valuation

Potential 450 MW	195	
Installed Capacity (MW)	180	360
Capacity Utilisation (%)	90	90
Capacity Utilisation (mn kw/h)	1,380	2,760
	0.0753	0.0753
Revenue (USDmn)	104	208
EBIT Margin:		
30%	31	62
Capex and Financing @ 15% of GPV (USDmn)	16	31
Pretax	16	31
Tax @ 35% (USDmn)	5	11
Net Attributable to SEPCO after tax (USDmn)	10	20
Melewar's portion @ 70% (USDmn)	7	14
Initial Investment Outlay (USDmn)	1	1
Enhancement (USDmn)	6	13
NAV @ RM3.50 per USD 1 (RMmn)	21	46
NPV 15%, 22 years	136	293
NAV per share	0.60	1.29

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