

MALAYSIA



BUILDING MATERIALS

RECOMMENDATION

OVERWEIGHT

NEUTRAL

UNDERWEIGHT

SECTOR FLASH NOTE

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Gas price hike & M&A spillover

The latest sector developments appear more negative for the steel companies than the cement ones. The 18-26% gas price hike is likely to be neutral for the cement players but will be negative for the larger steel mills. Ann Joo, the only steel stock under our coverage, faces minimal cost and EPS risk from the higher gas price as it makes up less than 1% of billet production cost, based on our estimates. Separately, the M&As by Lafarge's and Holcim's parent companies may have positive implications for domestic cement manufacturing strength and efficiency but it does not change the competitive landscape. Maintain Neutral on the sector and Hold on Lafarge and Ann Joo.

Figure 1: Latest developments affecting the cement and steel sectors

Issues	Impact/implications
18-26% increases in natural gas tariff	: Negative for steel millers; neutral for cement players : Gas cost makes up <1% of Ann Joo's billet production cost
Merger of parent companies of Lafarge & Holcim (implications for local subsidiaries)	: Likely positive impact on domestic prospects in Iskandar : Consolidation of plant operations; bigger market share : Potential to enhance cost efficiencies : But does not alter the oversupply risk and competition

SOURCES: CIMB, PRESS REPORTS

What Happened »

18-26% increase in gas tariff, M&A by parent companies of Lafarge and Holcim. Gas Malaysia has obtained government approval to raise the natural gas tariff in Peninsula Malaysia on 1 May. The price increase ranges from 18-26% for the consumers with an average annual gas consumption of 601mmBtu and above. On a separate note, it was reported that the parent companies of Lafarge and Holcim (non-listed) are likely to strike an M&A deal.

What We Think »

Gas price hike appears more negative for larger steel mills, minimal impact on cement players. The gas price hike is negative but largely expected in view of the recent diesel/petrol price increases and the average 17% hike in electricity tariffs following the government's subsidy rationalisation move. We believe that this will negatively affect the larger steel mills more than the other players like Ann Joo as electricity forms the bulk of its energy costs. Its gas utilisation is minimal and confined to the production of billets (less than 1% of billet production cost, based on our estimates). For steel players, the ability to pass on the higher energy cost could be limited by the depressed selling prices mainly due to China's dumping. The higher gas price is likely to be neutral for cement companies as coal is their main energy source.

What You Should Do »

Stay on the sidelines. The upward revision in gas tariff translates into greater cost risk for certain steel players. Although Ann Joo should be the least affected, especially in view of its improved plant efficiency, the full-year impact of the higher electricity cost has yet to be seen. For Lafarge and Holcim, we do not expect the M&A spillover to change the competitive landscape. However, it could trigger the consolidation/integration of plant operations, particularly in Iskandar, given the resilient cement demand driven by property and oil & gas.

Gas tariff increase »

Higher gas prices effective on 1 May. Gas Malaysia has obtained government approval to raise the natural gas tariff in Peninsula Malaysia on 1 May. The key points are:

- 1) The tariff adjustment follows the 14.9% increase in electricity charges announced in Dec 2013 as part of the government's strategy to cut subsidies and reduce its budget deficit.
- 2) The gas price hike is not applicable to liquefied petroleum gas or natural gas for vehicles. The tariff for residential consumers and those who consume less than 600 million metric British thermal unit (mmBtu) p.a. will remain unchanged.
- 3) For other classes of consumers with an average annual gas consumption of 601mmBtu and above, the price increase ranges from 18-26%.

Benefits of M&A by parent companies »

Lafarge and Holcim M&A. According to a recent Reuters report, Holcim of Switzerland unveiled a deal to buy France's Lafarge to create the world's biggest cement maker, with annual sales of US\$44bn. According to an article in The Edge Weekly, the new company will be called LafargeHolcim and the deal is slated for completion by next year. The key details are:

- 1) The merger will be conducted mainly through a share exchange between the mother companies of the locally based Lafarge Malaysia and Holcim. The merged business will be based in Switzerland and listed in Zurich and Paris.
- 2) The group will have a market value of close to US\$60bn as a result of the deal. This will help it slash costs, trim debt and better cope with the soaring energy prices, tougher competition and weaker demand that have negatively affected the sector since the 2008 economic crisis.

Lafarge's and Holcim's merger plans likely to have positive spillover effect on local subsidiaries. The unexpected news of the parent companies' merger may have positive implications for their local subsidiaries. In our view, the integration or consolidation of plant operations is a possibility as it would enable the group to benefit from better manufacturing efficiency and market presence. We believe that Lafarge and Holcim could capitalise on their prospects in Johor (Iskandar). Holcim's main plant (with an annual capacity 1.2m MT p.a.) is located in Pasir Gudang and it has 10 ready-mix concrete plants in the state. Lafarge also operates a 770k MT p.a. cement plant in Pasir Gudang. Lafarge has a strong financial position with cash of RM450m to consider such consolidation, which could result to a combined market share of almost 40% by our estimates.

Although the upcoming gas price hike is not likely to have a major impact the cement players, the full-year impact of the higher diesel/fuel cost and the average 17% electricity tariff increase could provide the main push factors to combine and streamline the cement manufacturing assets of both companies. Lafarge is the largest domestic player, with c.40% market share based on our estimates. Holcim is a smaller, unlisted player with roughly less than 10% market share. However, its main market is in Johor.

M&A benefits do not alter the domestic competitive landscape. We conclude that while the M&A benefits would benefit Lafarge's and Holcim's domestic operations, they will not alter the overall industry's competitive landscape. The current oversupply situation in the domestic cement industry is caused by capacity expansion and the emergence of new players. Based on the rough industry estimates, current total cement demand stands at around 20m MT but supply (rated capacity) is around c.27m MT. This has caused distortions in the cement selling prices, given the higher price rebates offered by the new players. The consolidation of Lafarge's and Holcim's domestic

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manufacturing facilities could enhance pricing power but may be futile in the current competitive environment, which is further exacerbated by cost risks.

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April 14, 2014

Corporate Governance Report of Thai Listed Companies (CGR). CG Rating by the Thai Institute of Directors Association (IOD) in 2013.

AAV – Good, **ADVANC** - Excellent, **AMATA** - Very Good, **ANAN** – Good, **AOT** - Excellent, **AP** - Very Good, **BANPU** - Excellent, **BAY** - Excellent, **BBL** - Excellent, **BCH** – Good, **BCP** - Excellent, **BEC** - Very Good, **BGH** - not available, **BJC** – Very Good, **BH** - Very Good, **BIGC** - Very Good, **BTS** - Excellent, **CCET** – Very Good, **CENTEL** – Very Good, **CK** - Excellent, **CPALL** - Very Good, **CPF** – Excellent, **CPN** - Excellent, **DELTA** - Very Good, **DTAC** - Excellent, **EGCO** – Excellent, **GLOBAL** - Good, **GLOW** - Very Good, **GRAMMY** – Excellent, **HANA** - Excellent, **HEMRAJ** - Excellent, **HMPRO** - Very Good, **INTUCH** – Excellent, **ITD** – Very Good, **IVL** - Excellent, **JAS** – Very Good, **KAMART** – not available, **KBANK** - Excellent, **KKP** – Excellent, **KTB** - Excellent, **LH** - Very Good, **LPN** - Excellent, **MAJOR** – Very Good, **MAKRO** – Very Good, **MCOT** - Excellent, **MINT** - Excellent, **PS** - Excellent, **PSL** - Excellent, **PTT** - Excellent, **PTTGC** - Excellent, **PTTEP** - Excellent, **QH** - Excellent, **RATCH** - Excellent, **ROBINS** - Excellent, **RS** – Excellent, **SAMART** – Excellent, **SC** – Excellent, **SCB** - Excellent, **SCC** - Excellent, **SCCC** - Very Good, **SIRI** – Very Good, **SPALI** - Excellent, **STA** - Good, **STEC** - Very Good, **TCAP** - Excellent, **THAI** - Excellent, **THCOM** – Excellent, **TICON** – Very Good, **TISCO** - Excellent, **TMB** - Excellent, **TOP** - Excellent, **TRUE** - Excellent, **TTW** – Excellent, **TUF** - Very Good, **VGI** – Excellent, **WORK** – Good.