Mercury Securities Sdn Bhd

UPDATE REPORT

25 Mar 2011

Yung Kong Galvanising Industries Berhad		***Market Price:***	*RM0.525*
		Market Capitalisation:	*RM102.7m*
		Board:	*Main Market*
Recommendation:	*HOLD*	***Sector:***	*Industrial Products*
Target Price:	*RM0.57*	***Stock Code/Name:***	*7020 / YUNKONG*

***Analyst**: Edmund Tham*

Yung Kong Galvanising Industries Berhad

Source: Yung Kong

BACKGROUND

Yung Kong Galvanising Industries Berhad (YKGI) is based in Kuching, Sarawak. It was listed on Bursa Malaysia back in October 1997. Incorporated in April 1977, YKGI is the pioneer in the steel sheet coil coating in East Malaysia.

"Steel sheet coil coating"

In 1989, YKGI expanded its market to Peninsular Malaysia. It then established a marketing arm in 1998 and set up a production facility in Klang, Selangor in 2000.

YKGI progressed further by integrating into the flat product steel segment to meet the growing demand in the building and construction sector, and also for industrial applications.

YKGI practises a prudent investment policy of focusing in what it knows best, creating a value-chain in order to position the competitiveness of its finished products. YKGI's business vision is "To be an integrated coated steel sheets producer and trader in the domestic and regional markets and to be ranked among the best".

YKGI – Major Early Milestones

Date	**Event**
Apr 1977	Incorporated as Yung Kong Products S/B, changed name to YKGI in 1979.
Feb 1983	Signing of JV with Marubeni Corp
Feb 1984	Start of sheet-by-sheet galvanising and corrugated sheet production
Feb 1989	Upgrade to coil-to-sheet galvanising
Mar 1991	Start of shearing of plain sheets
Aug 1992	Upgrade to coil-to-coil galvanising
Apr 1996	Start of CCL (Continuous Color Coating Line) at Demak Laut
Oct 1997	Listing on Bursa Malaysia
Feb 1998	SSM subsidiary was incorporated
Apr 1999	Obtained ISO 9002:1994
May 2002	Obtained 9001:2000, upgraded from ISO 9002:1994
Jul 2002	Acquired 24.8 acre land in Klang
Jan 2003	Transfer to Main Board
Sep 2004	SSM obtains ISO 9001:2000
Dec 2004	Obtains SMI Recognition Award Series 2004; SSGT and SSP subsidiaries get ISO 9001:2000
Jan 2005	Launch of YK2 NOF-CGL
Feb 2005	Construction of Cold Rolling Mill (CRM)
Mar 2005	Obtains Business of the Year 2004 award
Nov 2006	Magic Network S/B gets ISO 9001:2000
May 2007	Launching of CRM

Source: Yung Kong

List of YKGI's companies

Location	Description
	YKGI Bhd
Kuching	HQ and Factory 1
Klang	Office and Factory 2 (YK2)
	Subsidiary - Integrated Coil Coating Industries S/B (ICCI)
Klang	Manufacturing – Peninsular M'sia
	Subsidiary - Magic Network S/B (Magic)
Kuching	Marketing – East Malaysia
	4 subsidiaries - Star Shine Marketing (SSM) / Global Trading (SSGT) / Steel Products (SSP) / Industries S/B (SSI)
Klang	Manufacturing, marketing & export – Peninsular M'sia
Malacca	**Southern branch office**

Source: Yung Kong

**ICCI and Magic -100% owned subsidiary, SSM – 65% owned, SSP 75.5% owned, SSI 73% owned, SSGT 51% owned*

**Under an internal reorganisation to be completed in Q2 of 2011 - SSM, SSP, SSI and SSGT will be wholly-owned by Star Shine Holdings Bhd*

Yung Kong is headed by its Executive Chairman Dato Dr' Hii Wi Sing and Managing Director (MD) Mr Arthur Hii Lu Choon. The Hii family controls the group. Another major shareholder is Marubeni-Itochu Steel Inc, from Japan.

Dato Dr' Hii has more than 40 years of experience in the steel industry. He is a pioneer in the steel sheet galvanising sector in East Malaysia. Meanwhile, Mr Arthur is a son of the executive chairman. Mr Arthur has a professional accountant background and has been involved in the group's management for more than 10 years.

PERFORMANCE – FY10

4Q/ 31 Dec	4Q10	4Q09	yoy %	3Q10	qoq%
Rev (RMm)	119.1	94.6	25.9	105.0	13.4
EBIT (RMm)	0.8	12.5	(93.9)	4.6	(83.3)
NPAT (RMm)	(2.3)	6.8	(134.2)	1.8	(230.6)
EPS (sen)^	(1.1)	3.3	(134.2)	0.9	(230.6)

^same share base

12M/ 31 Dec	FY10	FY09	yoy %
Rev (RMm)	466.4	341.5	36.6
EBIT (RMm)	27.0	25.5	6.1
NPAT (RMm)	9.6	9.9	(3.8)
EPS (sen)*	4.7	5.5	(14.1)

**different share base*

The group's total revenue for 4Q/FY10 ended 31st December 2010 had improved by 25.9% or RM24.5 million to RM119.1 million, as compared to the revenue of RM94.6 million in the corresponding 4Q/FY09. The group had reported a 4Q/FY10 net loss after tax (NLAT) of RM2.3 million as compared to a net profit after tax (NPAT) of RM9.6 million reported in 4Q/FY09.

The increase in group revenue was due to the better demand for steel products, whereas the higher raw material cost and lower average selling price (ASP) of steel products had resulted in a situation of net loss after tax.

"Higher raw material costs, lower ASPs"

For full year FY10, the group had recorded revenue of RM466.4 million, 36.6% higher than the revenue of RM341.5 million recorded in its FY09. Nevertheless, the group's FY10 NPAT of RM9.9 million was 3.8% lower than the NPAT of RM9.6 million recorded, despite of the stronger y-o-y revenue. This could be attributed to the higher input costs from raw materials and also the weak average selling prices (ASPs) of its steel products.

OUTLOOK/CORP. UPDATES

The volatility in the movement of steel prices is indeed a concern to the steel product industry. The impact of the current diversion of prices between YKGI's raw material, Hot Rolled Coil (HRC) and its finished products is still affecting its operating results to an extent.

"Volatile steel prices a concern"

The reversal of the situation shall slowly be effected when the market is able to accept the increased cost of the production to be passed on to customers. YKGI manages to alleviate this issue by having a "cost plus" clause in its contracts with clients. In the meantime, YKGI's management would proceed cautiously in deciding the procurement the timing and quantity of HRC, which is in the upward price trend.

"Supply of HRC obtainable, but price is volatile"

In terms of HRC, YKGI is able to procure locally from Megasteel and also overseas. YKGI has relative ease in obtaining steel raw material from Nippon Steel Corporation (NSC) of Japan, via its substantial shareholder Marubeni-Itochu Steel Inc of Japan.

"Strategic partnership with NSC"

Furthermore in 2010, YKGI had forged a strategic partnership with Nippon Steel Corp (NSC), which will guarantee it with a steady long-term supply of raw materials at very competitive prices. NSC would supply up to 50% of HRC required by YKGI. The tie-up will also enable YGKI to get technical assistance by tapping into NSC's research and development (R&D) capabilities.

NSC is listed on the Tokyo Stock Exchange and is principally involved in steel-making and steel fabrication business. NSC has taken up a stake in YGKI through the acquisition of more than 21.7 million redeemable convertible preference shares (RCPS). NSC paid about RM13 million for the RCPS priced at 60 sen a piece. It could convert the RCPS into YGKI shares anytime within a 10-year period.

"Upward pressure on steel prices"

Looking at data from MEPS (International) Ltd, amidst volatile prices - 2010 HRC prices were generally higher y-o-y than the prices in 2009. MEPS is a leading consultancy company operating in the steel sector worldwide. According to MEPS, although there is good demand for steel from Asian countries such as China and China, the main factor pressuring steel prices upward is the cost of raw materials to make steel (such as iron ore and coking coal). The recent extreme flooding in Queensland, Australia, had also exacerbated the supply situation for coking coal.

As most of YKGI's steel products are sold locally, we will examine the local steel product demand situation in Malaysia. In tandem with the improving domestic economy (in GDP terms), the **local building and construction sector is expected to do well**. As such, we foresee no hiccups for YKGI in terms of demand for its steel products. YKGI is also planning to have some capital expenditure (capex) for its new colour coating line.

"Malaysian economy growing steadily"

The latest available Malaysian economic data (January 2011) revealed reasonably positive growth rates in y-o-y percentage terms, for instance: IPI (+1.0 y-o-y), Manufacturing Sales (+7.7% y-o-y), Exports (+3.0% y-o-y) and Imports (+13.5% y-o-y). Malaysia had also reported a very respectable 4Q/2010 GDP growth of +4.8% (+7.2% for full year 2010 GDP), stable 4Q/2010 unemployment rate of 3.2% and manageable CPI of 2.4% (January 2011). Meanwhile, Bank Negara Malaysia (BNM) had last reaffirmed its accommodative overnight policy rate (OPR) of 2.75% on 11th March 2011.

"Large Public Infrastructure Projects"

In 2010, the Malaysian federal government had announced a number of large projects under the 10th Malaysian Plan (10MP) and NKEA (National Key Economic Areas). 7 highway projects are planned at an estimated cost of RM15 billion. Among the projects are the West Coast Expressway, Guthrie-Damansara Expressway, Sungai Juru Expressway and Paroi-Senawang-KLIA Expressway. 2 coal electricity generation plants at an estimated cost of RM10 billion are also planned. The development of the Malaysian Rubber Board's land in Sungai Buloh, Selangor, covering an area of 3,300 acres at an estimated cost of RM10 billion is also at the planning stage.

The government also revealed a focus on increasing the coverage of basic infrastructure such as roads, electricity and water supply, and communication networks to rural areas. The government will build 6,300km of paved roads in Peninsular Malaysia, 2,500km in Sabah and 2,800km in Sarawak, which is expected to benefit 3.3 million people.

In line with the **"Greater Kuala Lumpur"** part of the NKEA, the government will further enhance the public transportation network in Kuala Lumpur with the implementation of the high-capacity Klang Valley Mass Rapid Transit (KV-MRT) system. When completed, the system is expected to cover a radius of 20km from the city centre with a total length of about 150km, and when fully operational, will serve up to 2 million passenger trips per day, compared to 480,000 trips on current urban rail systems.

Healthcare access, coverage and quality will also continue to be improved under 10MP. Among the major initiatives are the construction of 8 hospitals, including specialist hospitals, 197 clinics and 50 additional 1Malaysia clinics, which are expected to be ready within the first half of the 10MP. 78,000 affordable houses will be built during the 10MP period.

"Steel product demand expected from SCORE"

The Sarawak Corridor of Renewable Energy (SCORE) is one of the 5 regional development corridors being developed throughout the Malaysia. SCORE is a major initiative undertaken to develop the Central Region and transform Sarawak into a developed state by the year 2020. At the core of the Corridor is its planned energy resources (28,000 MW), particularly hydropower (20,000 MW), coal (5,000 MW), and others (3,000 MW). With the large amount of infrastructure projects planned within SCORE, we expect that some demand for steel products would flow down to YKGI as well.

VALUATION/CONCLUSION

Yung Kong's Board of Directors had proposed a first and final dividend of 1.25 sen per ordinary share tax exempt, for its FY10 ended 31st December 2010, to be approved by the shareholders at the forthcoming Annual General Meeting (AGM). The Board also proposed a first and final dividend of 1.375 sen per RCPS tax exempt for its FY10, pending approval at the next AGM. The dividends are to be paid on 31st May 2011.

"Reasonable dividends"

In recent years, Yung Kong's dividend payout ratios have been quite varied. We nevertheless expect that Yung Kong would be able to maintain a reasonable dividend payout ratio of at least 20-30% of its annual net earnings for its FY11.

With an adjusted beta (correlation factor) of just 1.25 to the KLCI, Yung Kong has slightly outperformed the KLCI this year (by +2.3% vs. -0.08% year-to-date (YTD)). Market conditions have also been volatile lately, impacted by the recent political uprisings in the Middle East/North Africa and major earthquake in Japan. Nevertheless, as Yung Kong is not an especially large market-cap stock, this may put a dampener on its market visibility and trading volume.

"Hold Call"

Based on our forecast of Yung Kong's FY11 EPS and an estimated P/E of 10 times (within its historical range), we set a FY11-end **Target Price (TP) of RM0.57**. This TP offers just 8.9% upside from its current market price. Our TP for PBA reflects a P/BV of merely 0.65 times over its FY11F BV/share. Meanwhile, the local "Iron and Steel" sector's average P/E and P/BV is 17.0 times and 0.75 times, respectively.

We find that Yung Kong's FY11F P/E and P/BV valuations are not pricey, while it has reasonable dividend yields and ROEs. The group's net gearing levels appear to be dwindling slightly year by year. Yung Kong is in a cyclical industry, and we would like to see Yung Kong achieve a more apparent and consistent earnings growth before considering whether to upgrade our call on it.

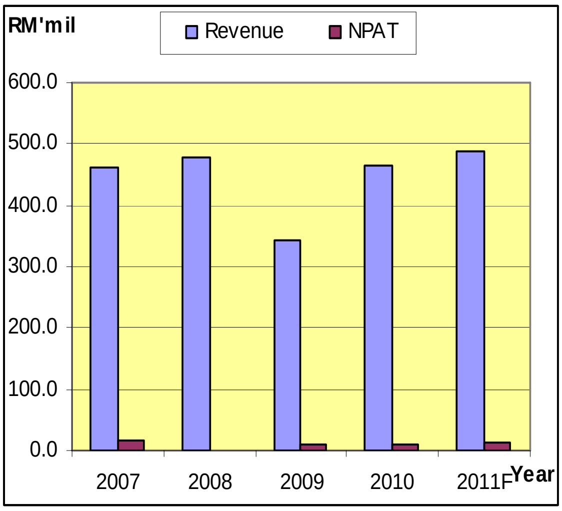
"Cyclical industry"

Meanwhile, Yung Kong's businesses also face risks such as a possible slower rate of economic growth, slow implementation pace of major infrastructure projects, weak demand for steel products, foreign exchange fluctuations, future hike in cost of utilities (electricity, gas), possible shortage of gas supply, slim net profit margins and also the rising costs of raw materials (HRC).

YUNKONG: 6-month Share Price

Source: NextView

Yung Kong: Revenue and NPAT trend



Source: Yung Kong
**2011F figures are our estimates*

YKGI – Recent Major Milestones

Date	Event
Jun 2007	Commissioning of P&O line
Sep 2007	YK2 moved into corporate office
Oct 2007	Commissioning of Splitting Line at YK2
Jan 2008	Commissioning of Acid Generation Plant
Apr 2008	Star Shine group moves to new location in Klang
May 2008	Commissioning of new Pipe Mill by SSI in Klang
May 2008	25th JV Anniversary of Yung Kong and Marubeni (MISI) Tokyo
Oct 2008	Launching of YK2 operations
Dec 2009	YK2 and ICCI accredited with ISO 9001:2008
Mar 2010	Signing of conditional Subscription Agreement & Steel Supply Agreement with Nippon Steel Corp (NSC)
May 2010	ISO 9001:2008 accreditation obtained
Aug 2010	YKGI & NSC Equity Strategic Partnership celebration

Source: Yung Kong

KEY FINANCIALS

Key Stock Statistics	2011F
EPS (sen)	5.7
P/E (x)	9.2
Dividend/Share (sen)	1.7
NTA/Share (RM)	0.88
Book Value/Share (RM)	0.89
Issued Capital (mil shares)	203.6
52-weeks share price (RM)	0.475 – 0.655
Major Shareholders:	%
.Yung Kong Co Bhd	27.3
.Marubeni-Itochu Steel Inc	18.4
.Dato' Dr Hii Wi Sing	12.6

**RM0.50 par value*

Per Share Data	2008	2009	2010	2011F
Book Value (RM)	0.80	0.85	0.84	0.89
Earnings (sen)	0.7	5.5	4.7	5.7
Dividend (sen)	0.8	3.3	1.7	1.7
Payout Ratio (%)	82.1	45.7	26.6	21.9
PER (x)	77.6	9.6	11.2	9.2
P/Book Value (x)	0.7	0.6	0.6	0.6
Dividend Yield (%)	1.4	6.3	3.2	3.2
ROE (%)	0.8	6.4	5.6	6.4
Net Gearing (cash) (x)	1.75	1.72	1.62	1.59

**Dividend figures reflect ordinary shares only*

P&L Analysis (RM mil)	2008	2009	2010	2011F
Year end: Dec 31				
Revenue	479.3	341.5	466.4	487.3
Operating Profit	19.6	26.4	30.8	35.5
Depreciation	(17.6)	(18.5)	(18.9)	(19.2)
Interest Expenses	(14.8)	(10.8)	(13.5)	(16.0)
Pre-tax Profit	4.8	15.6	17.3	19.5
Effective Tax Rate (%)	44.1	33.5	27.5	24.8
Net Profit	1.2	9.9	9.6	11.6
Operating Margin (%)	4.1	7.7	6.6	7.3
Pre-tax Margin (%)	1.0	4.6	3.7	4.0
Net Margin (%)	0.3	2.9	2.0	2.4

**2011 figures are our estimates*