

EZZ STEEL

STRONG OPERATIONS AMIDST UNCERTAIN TIMES

Buoyant domestic demand, market leadership and import parity pricing lead Ezz Steel's operational growth

We forecast an 11.6% Y-o-Y increase in Ezz Steel's top line to EGP 20,773 million in 2012 and a CAGR of 7.7% for our five-year forecast period through 2016. Our outlook is backed by persistent strong demand for long products that will more than offset for the slowdown in the demand for flat steel. The fast-growing population which exceeds 83 million and a high marriage rate are fuelling housing demand that is further critical at the low-income household levels. A report by BMI forecasts that annual crude steel output in Egypt will have to reach 11 million tons by 2016 to keep up with the domestic demand, representing a 72% jump over 2011 levels.

Ezz Steel's domestic market share tops 60% for both long and flat steel supported by a large capacity of 5.8 million tons of finished steel, which enables the company to satisfy a large portion of the local demand for the metal. Although steel imports from Turkey and Ukraine have resumed since the beginning of 2012, the steelmaker's operations are protected by the fact that the company prices its products on import parity basis, and that imports only cover the supply gap in the local market.

Fully integrated and flexible production to boost margins and further widen gap with peers

Ezz Steel enjoys higher margins compared to peers, a position that has been granted through its vertically-integrated subsidiary EZDK. The company plans to more than double its annual DRI capacity to integrate production at its EFS and ESR plants, through the construction of two DRI factories in Ain el Sokhna, Suez. This will improve overall profitability through lowering these plants' reliance on imported billets. On another front, EFS's planned meltshop expansion will further increase the company's flexibility for producing either long or flat steel and enable it to respond faster to the market needs, thus increasing utilization and improving efficiency.

Despite the steel licenses being revoked since Q4 2011, we expect that Ezz Steel will be able to complete construction of its DRI factories, especially after the government announced that it would be willing to sell the steel licenses back to Ezz Steel for their estimated cost of EGP 660 million. Following, we expect the gross margin to improve over our five-year outlook, to reach 13.4% in 2016 up from 11.9% in 2011, backed by higher sales volumes and as the company reaps the benefits of production integration.

Outstanding risks should be carefully watched

Ezz Steel trades at a 18.7% discount to its historical five-year average EV/EBITDA, an unjustifiable markdown that is attributable to investors' concerns over political stability in Egypt and over the future operations of the company amidst outstanding legal claims and major uncertainties. Such risks include: i) negative legal outcomes concerning the DRI licenses and Ahmad Ezz's acquisition of EZDK, ii) erosion of dividends' purchasing power on the Pound depreciation, iii) radical lift in natural gas subsidies, iv) further liquidity concerns for an-already highly leveraged balance sheet. The highest threat to the stock price of Ezz comes from a recent court ruling that fined Ahmad Ezz EGP 19.3 billion for corruption charges, and which might force him to sell all his shares in the company, resulting in a severe drop in the stock price, given his 66% ownership stake at Ezz Steel. While acknowledging the fact that such threats could affect the short-term price performance, we believe that attractive valuation would persist under reasonable scenarios, and thus initiate on Ezz Steel with an accumulate rating and a fair value EGP 13.39 per share, representing an upside potential of 28.7% over the current share price.

FINANCIAL DATA

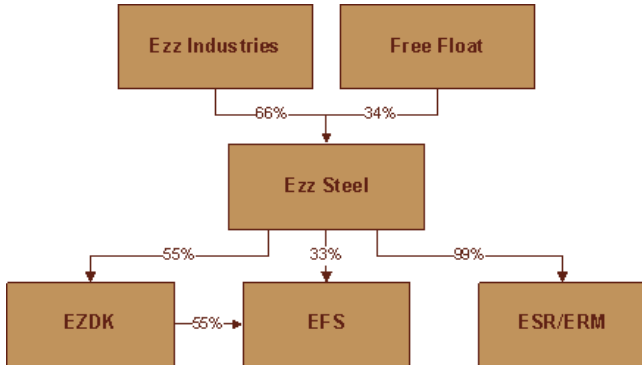
	2011	2012e	2013e	2014e	2015e	2016e
Revenues (in EGP mn)	18,611	20,773	24,288	24,903	26,514	27,921
EBITDA (in EGP mn)	2,440	2,378	2,745	3,115	3,384	3,639
EBITDA Margin (%)	13.1%	11.4%	11.3%	12.5%	12.8%	13.0%
Net Profit (in EGP mn)	202	270	403	558	649	738
Net Profit Margin (%)	1.1%	1.3%	1.7%	2.2%	2.4%	2.6%
EPS (in EGP)	0.37	0.50	0.74	1.03	1.19	1.36
P/E (x)	28.11	20.92	14.01	10.13	8.71	7.65
ROAE (%)	3.1%	3.8%	5.3%	7.0%	7.6%	8.4%

COMPANY PROFILE

OWNERSHIP AND STRUCTURE

Ezz Steel is largely owned by Ezz Industries, a conglomerate that is wholly owned by Ahmad Ezz and which includes:

- Al Ezz Group Holding for Industry and Investment
- Egyptian International Company for Commercial Investment
- Egyptian Global Company for Industrial Investment
- Tanmiya Company for Metal Investments



Ezz Steel is the largest steel maker in the MENA region with an aggregate capacity of around 5.8 million tons per year. The company produces both long and flat steel through its three subsidiaries:

El Ezz Dekheila Steel Company – Alexandria (EZDK): The plant has an annual capacity of 3 million tons of steel, representing around 52% of Ezz Steel's total capacity, divided between 2 million tons of long steel capacity and 1 million ton of flat steel capacity. Production at EZDK is fully integrated since the company internally produces Direct Reduced Iron (DRI) with an annual capacity of 3.2 million tons. EZDK is 55% owned by Ezz Steel and 40% owned by public institutions, with a free float of 5%.

Al Ezz Flat Steel (EFS): The plant operates a meltshop which provides liquid steel and is tailored to the production of either long or flat steel at an annual capacity of 1.3 million tons. This offers the company flexibility in production in order to meet any surging demand for any of the two products. EFS uses mostly scrap in its production process; however a shift to DRI is underway at the plant through two expansionary projects. These would result in an aggregate DRI capacity of 2.8 million tons, at an approximate cost of EGP 660 million for both projects.

The first phase is near completion. However, due to pending litigations concerning the acquisition of both steel licenses, we expect that the new capacity will not come into effect in the near term.

EFS is 55% owned by EZDK and 33% directly owned by Ezz Steel. After accounting for the indirect stake through EZDK, Ezz Steel's total ownership of EFS stands at 64%.

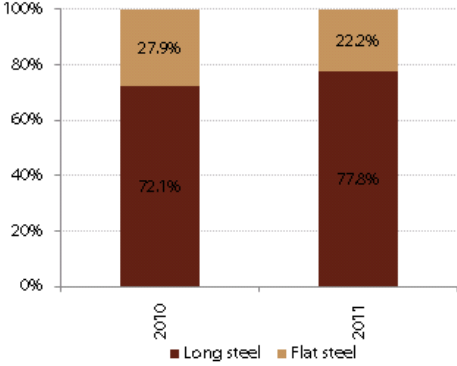
Al Ezz Steel Rebar (ESR)/ Al Ezz Rolling Mill (ERM): ESR has an annual capacity of 1.5 million tons of long steel, while ERM is a rolling mill. ESR uses mainly scrap for the manufacturing of steel but the plant is expected to start using DRI after the completion of phase 1 of the project which would contribute around 900,000 tons of annual DRI capacity. ESR and ERM are each 99% owned by Ezz Steel.

LOCAL AND FOREIGN DEMAND DISTRIBUTION PER PRODUCT

Long steel products, which consist of rebar and wire rods that are used in construction projects, are the main contributor to the company's sales, with 3.6 million tons sold in 2011, or 78% of the company's total sales volumes during the year. Long steel sales are backed by the increasing demand for residential units in Egypt, and which has been fuelled by a severe shortage in housing. Private home builders constitute the main driving force behind the demand for the company's long steel, which is provided to them through distributors, both wholesalers and retailers, as the company does not sell its products directly to end users. On the other hand, sales of flat steel which consists of hot rolled coil used in industrial manufacturing stood at 1 million tons in 2011, around 22% of the steel maker's total sales mix. That was lower than 2010's contribution of almost 28% due to:

- ☞ The slowdown in industrial manufacturing in Egypt during 2011 amidst highly uncertain times and following the January 25 revolution that saw the production activity in the country slowing during the first few months of the year.
- ☞ Recessionary pressures in Europe where industrial production growth has taken a severe hit over the past few years.
- ☞ The suspension of flat production in EFS facility during 2011 due the installation of the new long product mill.

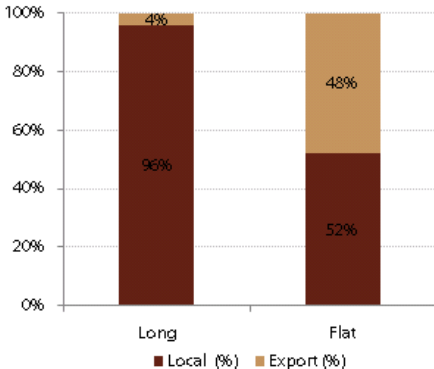
Chart 1: Sales volume distribution by product (%)



Source: Company Reports

The strong domestic demand has been consistently exhausting most of the company's long steel, leaving only a negligible share for export markets. On the other hand, sales of flat steel, which previously catered mostly for foreign markets, witnessed last year an increase in contribution from the Egyptian market which consumed 52% of total flat steel sales, compared with 41% in 2009. In addition, with a booming construction sector, Gulf countries overtook Europe's top share of the product sales at 60% in 2011.

Chart 2: Local and export sales by product in 2011 (%)



Source: Company Reports

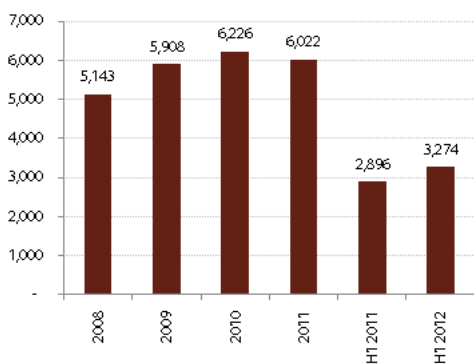
INVESTMENT RATIONALE

RESILIENT DOMESTIC DEMAND LEADS EGYPTIAN STEEL SECTOR'S GROWTH

Persistent domestic demand has led Ezz Steel's operations ashore during 2011, despite the stormy political, legal and economic environment that resulted in steel demand and production disruptions in Egypt. Steel sales volume at Ezz managed to remain flat, on an aggregate level, as the 7% Y-o-Y increase in long steel sales to 3.6 million tons counterbalanced the 21% Y-o-Y drop in flat steel sales. Still, Ezz posted a 12% Y-o-Y jump in revenues. The company's top line was boosted by higher steel prices due to the global rise in prices of iron ore and scrap last year. Long products at Ezz traded at an average of EGP 4,546/ton in 2011, up by 25% Y-o-Y, while flat product prices edged up by 15% Y-o-Y to average EGP 4,964 per ton, during the same period.

The main catalyst to the price hike however, was the resilient domestic demand which withstood recessionary pressures in the country and the delay in many of the public construction projects. This was mainly the result of strong demand from private homebuilders, who constitute 65% of local consumption. The low-income housing crisis and the relaxed regulatory environment that coupled the political transition initiated a wave of illegal construction on agricultural land and in overpopulated areas. This slightly offset disruptions in local steel consumption which edged down by 3.3% Y-o-Y to 6,022 tons in 2011.

Chart 3: Egypt Steel Consumption (in thousand tons)



Source: Egypt Information Portal

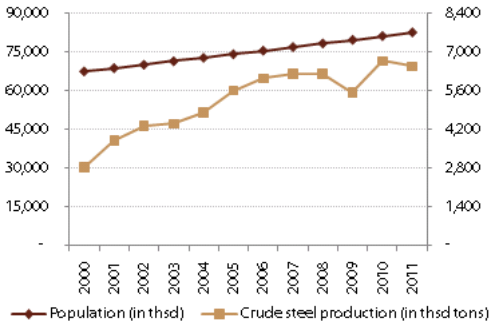
Despite our belief that the demand from illegal construction activity is unsustainable, especially with the appointment of a new governing body in Egypt that will revamp the regulatory environment, the country's construction sector can rely on the upcoming rebound in the genuine demand, backed by robust demographic fundamentals which are leading the demand for housing.

STRONG DEMOGRAPHIC BASE BUOYS DEMAND FOR REAL ESTATE IN EGYPT

With a population exceeding 83 millions and that is expected to double to 160 million in the next 25 years, the real estate sector in Egypt suffers from severe shortage in affordable housing units; a situation that becomes further critical when considering the strong annual population growth at around 2% and the high marriage rate which tops 800,000 per year. Indeed, the large and fast-growing population constitutes a key variable for the demand for metals used in the construction and manufacturing industries, and which has positioned Egypt as the second largest producing country of steel in the MENA region, behind Iran.

Also, the nature of property as a protection against inflation and a hedge against currency devaluation also contributes to boosting demand for housing, especially from the substantial expatriate Egyptian population in the Gulf and whose remittances topped \$13 billion in 2011, further contributing indirectly to the rise of the domestic demand for steel.

Chart 4: Egypt population versus domestic steel production



Source: World Bank, World Steel Association

On another front, major catalysts for steel consumption in Egypt are the government’s infrastructure and large housing projects, and big construction companies’ projects. The infrastructure industry contributed to around 46% of the total value of the construction industry in Egypt for 2011, according to a recent report by Market Research, representing a solid CAGR of 15% during the period from 2007 to 2011. This growth was primarily attributed to significant infrastructure investments made by the Egyptian government, including three stimulus packages, coupled with stepped-up private investment in Egyptian infrastructure development during the period.

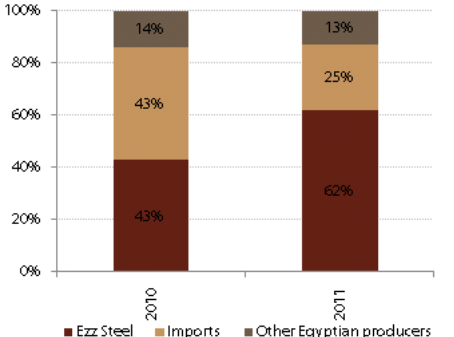
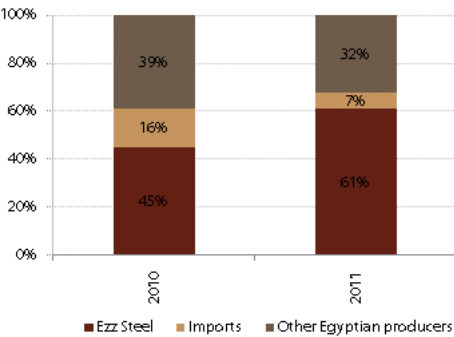
Demand from both public and large private clients has been subdued due to the overhaul in the political structure in the country and the lawsuits that a number of major real estate developers are facing. In addition, economic turmoil in which the country has been sinking for almost two years now, is not expected to show significant improvements at least until the end of 2013. Yet, we believe that the modest public and private investments in the country’s juvenile infrastructure and real estate sector, including the ongoing public-funded low-income housing projects, will suffice to support the local demand for steel in the near term.

For the longer term, demand for the metal is expected to accelerate, led by the policies of the new government to promote fiscal sustainability and create an attractive environment for foreign investors, with the aim of stimulating public-private partnerships. A target of EGP 276 billion in total investments has been set for the fiscal year ending next June.

AN INCONTESTABLE LEADERSHIP POSITION IN THE LOCAL MARKET, SHIELDED BY IMPORT PARITY PRICING

Ezz Steel benefits from an indisputable share in the Egyptian market for both long and flat steel. The steel maker’s market share of each product tops 60% and stands way above other Egyptian manufacturers’ individual shares of around 10%. This leadership position is supported by a large capacity of 5.8 million tons of finished steel, and an annual production of around 2.6 million tons of finished products in H1 2012, up by 16% Y-o-Y, which enables the company to satisfy a large portion of the local demand for the metal.

Chart 5: Long steel local market share distribution **Chart 6: Flat steel local market share distribution**



Source: Company reports

Source: Company reports

The substantial increase in the steelmaker's market share in 2011, up from around 45% the year before, occurred on the back of a 4.7% Y-o-Y increase in the company's long steel production, coupled with a substantial drop in imports last year. On one hand, export channels to Egypt were disrupted during the first few months of the year, resulting in a plunge of more than 85% Y-o-Y in Turkish steel exports to Egypt in February 2011. On the other hand, Egyptian importers of Turkish steel suspended new orders of rebar following a surge in the price of billets which rendered prices of these imports unattractive compared to the price of locally-produced steel.

During H1 2012, local steel sales recorded a 13% Y-o-Y increase to 3.3 million tons, and long steel imports from Turkey and Ukraine started to recover. Still, the imports' resurgence does not threaten the steel maker's operations, due to the following:

- ☞ Imports only cover the supply gap in the Egyptian market, and thus Ezz Steel's operational growth is solely correlated to higher utilization and capacity expansion.
- ☞ Ezz Steel prices its products on import parity basis and adjusts selling prices on a monthly basis. This erases the threat of imports and dumped foreign steel.

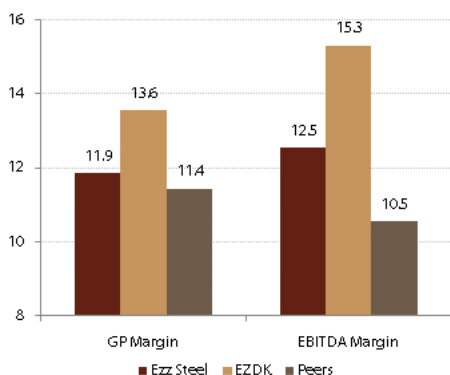
FULLY INTEGRATED AND FLEXIBLE PRODUCTION TO BOOST EZZ'S MARGINS AND FURTHER WIDEN GAP WITH PEERS

Ezz Steel enjoys higher margins relative to peers, a position that has been granted through its vertically-integrated subsidiary EZDK.

Vertical integration is a steel producer's major catalyst towards superior margins due to the substantial production efficiency benefits. EZDK, through its in-house production of DRI, has consistently delivered better margins than its standalone counterparts EFS and ESR who rely on imported billet and scrap as their main feedstock, as internal production of DRI enables the company to control costs amidst the highly volatile global commodities market.

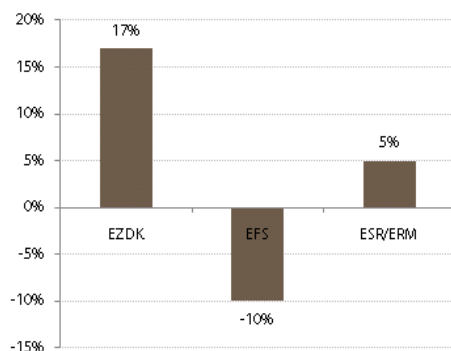
On another front, Ezz Steel recently commissioned a meltshop with a production capacity of 1.3 million tons of either long or flat steel. This horizontal integration of activities will enable the company to tailor its activities according to the market needs and thus improve sales and margins while also preserving its market share.

Chart 7: Margins vs. peers



Source: Bloomberg

Chart 8: Gross profit (loss) margin by plant



Source: Company reports

In a move to improve production efficiency across the different subsidiaries of Ezz, the company launched in 2009 the first phase of a DRI capacity expansion project. The first plant is owned by ERM and is based in Ain Sokhna in Suez, with a planned capacity of 1.85 million tons. The project, valued at around \$400 million, will serve the EFS meltshop which will exhaust more than 50% of the new capacity, while the remaining capacity will serve ESR. In addition, the first phase includes a \$75-million investment for the establishment of a new meltshop at EFS, also based in Suez.

Phase 2 of the project will consist of the construction of a second DRI factory which will be fully

owned by EFS and aims to serve the meltshop expansion facility. This phase will entail an investment of \$400 million and is expected to boost Ezz Steel's annual DRI capacity by an additional 1.85 million tons.

The company was expected to start production at the first DRI facility during H2 2011, but the construction project is currently on halt, at 80% completion, since October 2011, after an Egyptian court ruling withdrew both steel licenses from the company. The ruling claims that Ahmad Ezz, former Chairman of Ezz Steel, illegally acquired the DRI licenses free of charge - while these are estimated to cost around EGP 660 million – due to his close ties to the former Mubarak regime.

On a positive note, the government announced that it would consider the option to sell the steel licenses to Ezz Steel for their estimated cost and suggested a payment scheme which consists of a 15% upfront payment, an 18-month grace period, and the outstanding amount being settled over a 5-year period. This would allow Ezz to complete the construction of the first factory without excessively burdening its balance sheet.

While we do not expect that the case of the licenses' acquisition will be settled before year-end, we believe that the DRI capacity and the meltshop expansion projects will improve Ezz Steel's profitability on the longer run through:

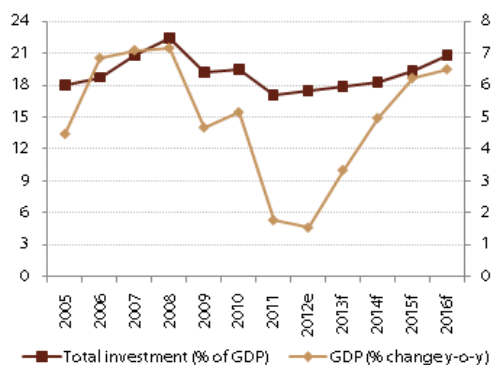
- 📁 lowering ESR's and EFS's reliance on imported billets.
- 📁 increasing the flexibility of EFS and allowing it to operate at full capacity even when the demand for flat steel fluctuates.

RECENT DEVELOPMENTS HINT TO AN UPCOMING RECOVERY IN INVESTMENTS IN EGYPT'S CONSTRUCTION SECTOR

The construction sector is one of the Egyptian economy's most active sectors, and the industry is crucial to the country's economic progress, accounting for 4.7% of Egypt's GDP.

The performance of the steel industry is highly correlated to the strength of the domestic economy, and it follows that attracting substantial international interest is key to pushing Egypt's steel industry to its full potential.

Chart 9: Historical and expected investment trend in Egypt



Source: IMF

Since his rise to power, President Mohammad Mursi has initiated a wave of positive political and economic developments that have substantially relieved fears about the Muslim Brotherhood-led government opposing economic liberalization and adopting Shariaa-based practices that would jeopardize the future of the tourism sector and foreign investments in the country.

On the political front, fears of tensions with Israel have been eased by Mursi's announcement that he would respect the peace treaty with Israel, while the smoother-than-expected transition to powers to the new government from the military rule breathed a sign of a recovery of an internal political stability.

On the economic front, the emerging political stability could speed up the approval of the much-anticipated \$4.8 billion IMF loan that will possibly alleviate the country's balance of payments and lead the way to a \$500 million funding by the African Development Bank. In addition, a wave of international sovereign investments into the troubled economy will partake in relieving the fiscal budget. Qatar announced a five-year investment program worth \$18 billion in Egypt's electricity, natural gas and tourism projects, following a \$2 billion aid package that debuted in August, while Turkey pledged a similar package to support foreign currency reserves. Also, France granted Egypt EUR300 million to finance the construction of a new metro line.

Moreover, a visit by US government officials and business people in September triggered the announcement of a new wave of foreign private investments. The government has signed FDI contracts worth EGP4.2 billion, including an EGP1.4 billion contract for establishing a plant for Korean company Samsung, an EGP1.3 billion contract to establish a joint steel plant with Italy, and an EGP1.5 billion contract for the development of a Chinese industrial area in the west of the Gulf of Suez.

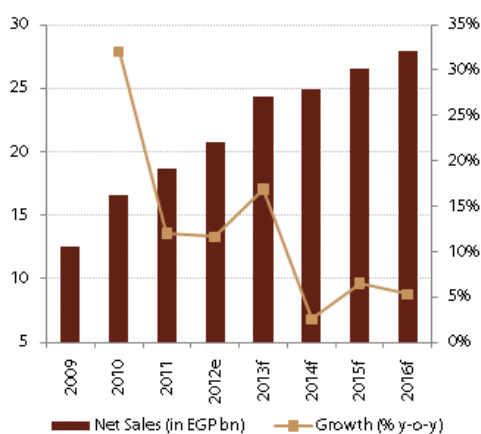
FORECASTING ROBUST OPERATIONAL GROWTH AND IMPROVED MARGINS OVER OUR INVESTMENT OUTLOOK

We anticipate an 8% Y-o-Y increase in long steel sales to 3.9 million tons for 2012, as long steel production at EFS comes into line, while we expect a 10% Y-o-Y drop in flat steel sales to 931 thousand tons as flat production continues to be depressed by subdued global demand. In aggregate, we forecast a 4% Y-o-Y growth in sales volumes, to around 4.8 million tons in 2012.

On the pricing front, we expect an 8% Y-o-Y drop in local long steel prices to around EGP 4,200/ton and a 10% drop in local flat steel prices to around EGP 4,500/ton, as the slowing economic growth in China - the largest producing country - pressures demand for steel.

Combining our assumptions, we anticipate an 11.6% Y-o-Y increase in revenues at Ezz Steel to EGP 20,773 million, and a CAGR of 7.7% to EGP 27,921 million through 2016, led by the resilient domestic demand for the metal. In fact, annual crude steel output in Egypt will have to reach 11 million tons by 2016, to keep up with the domestic demand, representing a 72% jump over 2011 levels, according to a report by BMI.

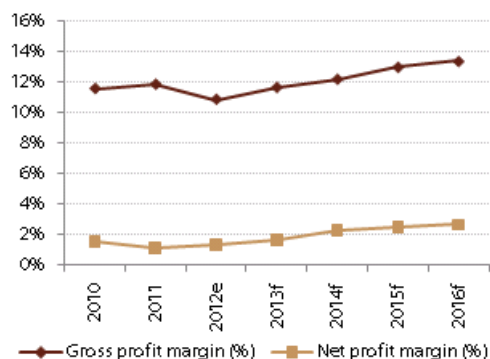
Chart 10: Ezz Steel revenue



Source: Company Reports; ASIB estimates

On the margins levels, we expect Ezz Steel to post a gross profit margin of 10.8% in 2012, a slight decline over its 2011 levels of 11.9%. That still constitutes an improvement compared H1 2012, when the company posted a gross margin of 9.7%, as global iron ore prices were lower during this year compared with their levels in the same period in 2011. Over our five-year outlook, we however expect Ezz Steel's gross margin to substantially improve to 13.6% due to higher sales volumes and as the company reaps the benefits of production integration.

Chart 11: Ezz Steel's margins

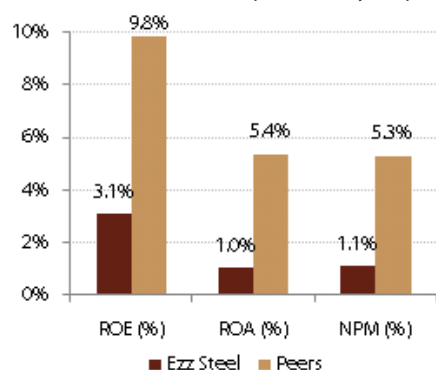


Source: Company reports, ASIB estimates

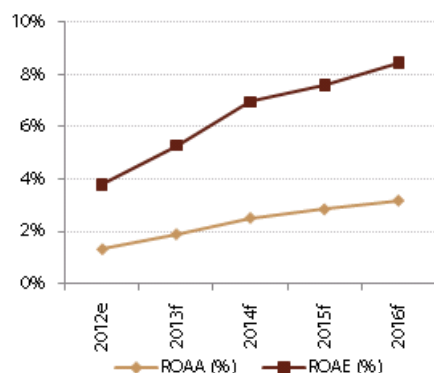
Ezz Steel's profitability took a hit in 2011, mostly due to one-off charges, related to income and deferred tax expenses, which if overlooked, would have resulted in a 60% Y-o-Y growth in the steel maker's bottom line to around EGP 400 million, instead of the actual 20% Y-o-Y drop to EGP 202 million.

We expect results to improve in 2012 as net profit to equity holders jumps by 33.7% Y-o-Y to EGP 270 million in 2012, and forecast a bottom-line CAGR of 28.6% from 2013 to 2016, to reach EGP738 million.

Chart 12: Ezz Steel's 2011 profitability vs. peers **Chart 13: Ezz Steel's profitability ratios beyond 2011**



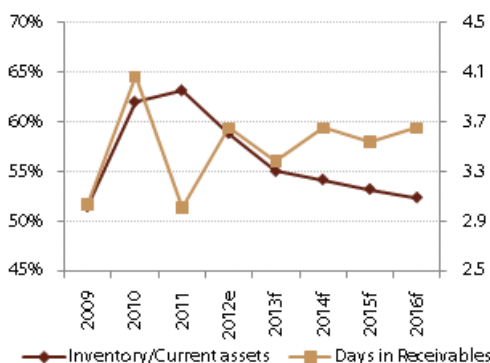
Source: Company reports



Source: ASIB estimates

On another front, Ezz Steel has been very efficient in managing its current assets. The company deals with distributors who place the inventory where the market price is best, and thus does not deal directly with clients. This reduces the number of days sales in receivables, which have consistently stood below 4 days at Ezz, compared with around 50 days for peers in 2011. Also, the strong demand in Egypt will pressure inventory levels down against current assets during the coming few years to average around 55% during our outlook, from 63% in 2011.

Chart 14: Management of inventory and receivables



Source: Company reports, ASIB estimates

VALUATION

We valued Ezz Steel at EGP 13.39 per share, representing a 28.7% premium over the share's last closing price, by combining the Free Cash Flow to Equity (FCFE) Model which is based on the fundamental analysis of the company, and the Relative Valuation model.

DISCOUNTED FREE CASH FLOW MODEL

We determined the fair value of Ezz at EGP 13.99 per share under the FCFE model, using the sum-of-the-parts approach, a discount rate of 20% and a terminal growth rate of 3%.

Table 1: Sum-of-the-parts valuation

In EGP million	Value	Ownership	Value contribution
EZDK (consolidated)	10,765	55%	5,921
EFS	172	33%	57
ESR	1,640	99%	1,624
Total Value			7,601
Nb. of shares outstanding			543
Est. Fair value/share			13.99

Below is a table that displays the sensitivity of our target price to different discount and terminal growth rates.

Table 2: Sensitivity Analysis

Cost of Equity	Terminal Growth Rate			
	in EGP	2.5%	3.0%	3.5%
19%		14.51	14.75	15.00
20%		13.79	13.99	14.20
21%		12.97	13.32	13.51

RELATIVE VALUATION

Using Ezz Steel's five-year historical average EV/EBITDA of 6.3x, we derived a fair value of EGP 12.79 per share.

Table 3: Relative Valuation

EV/EBITDA (in EGP)	
Ezz historical 5-year average EV/EBITDA	6.3
Ezz average 2012-2016e EBITDA (in EGP mn)	3,052
Enterprise Value (in EGP mn)	19,229
Less: Net debt position	(10,342)
Less: Minority Interest	(1,940)
Equity Value of Ezz Steel	6,947
Nb. of shares outstanding (mn)	543
Fair Value/Share (in EGP)	12.79

FAIR VALUE AND RECOMMENDATION

High political and economic uncertainty, coupled with investors' loss of confidence in the company's management triggered a severe stock sell-off trend in 2011. The stock is trading at a 45.5% discount based on its average historical P/B despite the steel maker's resilient operational performance.

Chart 15: Ezz Steel historical P/B



Source: Bloomberg

We believe that the price discount is unsustainable given the company's leadership position in the Egyptian market and the severe shortage in housing units which Egypt is suffering from and that is expected to lead a further boost in demand for construction materials.

We initiate coverage on Ezz Steel with an accumulate rating and a fair value of EGP 13.39 for the stock, using the weighted average fair value of our DCF and the relative valuation models.

Table 4: Ezz Steel's fair value

	Fair Value	Weight	Final Valuation
DCF	13.99	50%	7.00
Relative Valuation	12.79	50%	6.39
	Fair Value/Share		13.39

INVESTMENT RISKS

REVOKED STEEL LICENSES ARE NOT GRANTED BACK

During late 2011, a court ruling sentenced Ahmad Ezz to 10 years in jail and revoked the two most recent steel licenses that were granted free of charge for the purpose of developing two DRI production facilities. One risk arises in the case that those licenses are not granted back to Ezz Steel. This scenario could occur due to the close relationship of Ahmad Ezz - the largest shareholder of the company and former chairman - to the Mubarak family, and who was at the center of the public wrath during last year's uprising.

We developed three scenarios that portray our DCF fair value sensitivity to the outcome of the steel licenses case:

- Best case scenario: Ezz Steel Pays EGP 660 million, the price of steel licenses, and completes the construction of both DRI phases and the meltshop expansion project in EFS.
- Base case scenario: Ezz Steel pays EGP 660 million along with an additional penalty assumed at 20% of the original estimated cost of EGP 660 million, resulting in a total payment of EGP 792 million.
- Worst case scenario: Ezz Steel is not granted the licenses back even with the potential payment of a penalty.

Table 5: Scenario analysis

	Est. Fair value/share
Best case	13.75
Base case	13.39
Worst case	8.78

Although the Egyptian government supports that penalties be imposed on companies indicted for acquiring licenses free of charge (Bishay Steel, Tiba Steel, Suez Steel and Ezz Steel), it opposed withdrawing those licenses in order to protect the steel industry's operations. Also, with Ezz Steel recently cleared of monopoly claims by Egypt's competition body, we expect that the risk it won't be granted those licenses back remains limited.

EZDK ACQUISITION DEEMED UNLAWFUL

Ahmad Ezz gradually acquired 55% of EZDK since 1999, while the company, formerly El Dekheila – Alexandria, was facing financial difficulties. The acquisition was done in phases and funded through bank loans.

Ahmad Ezz is currently facing allegations for illegally taking control over EZDK in order to supply Ezz Steel with steel at reduced prices. A court ruling deeming the sale of EZDK shares to Ahmad Ezz unlawful, could result in two different scenarios:

- Under the first scenario, Ahmad Ezz would be forced to pay a penalty, which if substantial, would force him to sell his 66% ownership stake in Ezz Steel, resulting in a severe drop in the stock price.
- Under the second scenario, the court could cancel EZDK's acquisition, leaving Ezz Steel with a 33% ownership of EFS and the full ownership of ESR/ERM, for a combined fair value of EGP 3.09 per share.

EGYPTIAN POUND DEVALUATION

While bets are heading towards a gradual fall of the Egyptian Pound instead of a previously anticipated devaluation, the potential depreciation of the Pound would actually reflect positively on Ezz Steel's operations, since the company sells its products in US Dollars and a devaluation would increase reported revenues. Also, the depreciation of the Pound would reflect in relatively lower labor and energy costs, resulting in higher margins. However, the major hit comes from the erosion of shareholders' value through pressuring the purchasing power of dividends.

ENERGY SUBSIDIES ARE RADICALLY LIFTED

Egyptian steel producers rely on natural gas subsidies to maintain their low-cost advantage against global producers. However, the government has recently announced its intention to increase natural gas prices in a move to alleviate the burden on the fiscal budget, which matches the IMF's requirement of certain reforms to grant its \$4.8 billion loan to Egypt, including a lift of subsidies.

A coupon system designed to cut energy subsidies which constitute around 25% of the fiscal budget, and that would be tailored to benefit low-income households and small businesses has been suggested. Its implementation would force large businesses to purchase natural gas at near global prices.

At Ezz Steel, energy costs which currently constitute around 10% of the production costs base could see that ratio substantially increase as a result of a removal of natural gas subsidies. This would result in lower margins for the steel producer, especially given that Ezz prices its steel on import parity basis, and cannot pass on the higher costs to consumers. Also, increasing the company's product prices would open the way for foreign competition to eat into Ezz's market share.

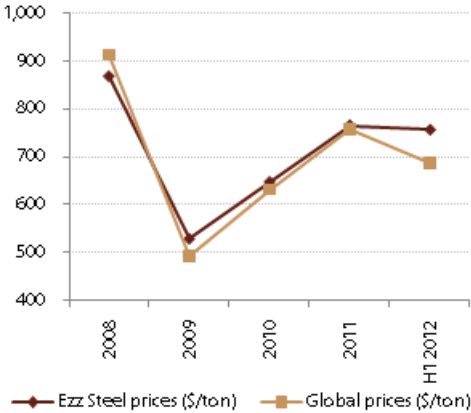
GLOBAL RAW MATERIAL PRICE VOLATILITY

Steel producers' profitability is highly sensitive to the fluctuations in raw material prices, which in turn is sensitive to the economic cycle. During economic boom, steel producers enjoy strong margins as demand for the metal increases with construction and manufacturing activity, while during recessions margins are squeezed due to the low demand and the drop in feedstock prices.

During 2009, Ezz Steel witnessed the biggest hit to its profitability as its gross profit margin dropped to 11.6% from 19.8% in 2008. This slump was partly due to the drop in the global steel prices, but mostly since the company which used to book iron ore on a yearly basis, ordered the iron ore at high prices just before it witnessed a severe slump in 2009.

In order to manage its exposure to fluctuations in global prices, Ezz now books its iron ore on a quarterly basis. While this reduces the volatility risk of the company's margins, it does not fully hedge such risk, especially since there's still a lag between the global raw material and steel price adjustments.

Chart 16: Ezz Steel versus global price movements



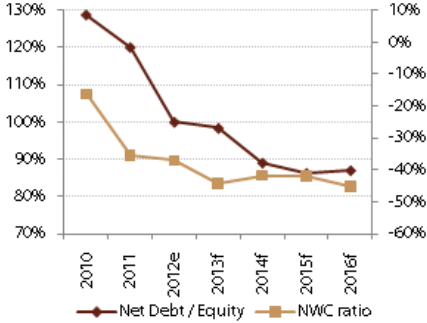
Source: Company Reports, Bloomberg, ASIB

On another front, the shabby global demand outlook for the FY 2012 on the slower growth in China and the recession in Europe, is pressuring steel prices. These have dropped by around 10% during the first half of the year compared with the average price in FY 2011, and we do not see any constant rebound in prices in the short term. This would reflect through a lower top line for Ezz Steel, especially since we believe that steel prices in Egypt would slightly decline during H2 2012 to reflect the drop in the global market, despite a resilient local demand. Still, producers' margins will somehow be protected by lower iron ore and scrap prices.

HIGHLY LEVERAGED BALANCE SHEET

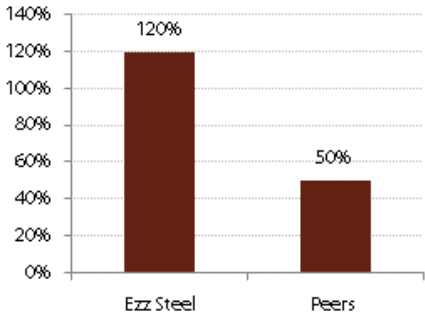
Ezz Steel relies heavily on borrowings to finance its working capital. Investments in the DRI expansion project also contributed to pressuring liquidity after the company launched the first phase in 2009. The Egyptian steelmaker’s net debt stood at 1.2x equity in 2011 compared with 0.5x for its peers. However, we expect the ratio to average 0.94x over the coming five years although the company continues its investments in vertically integrating its production process, as the volume of funding of working capital drops on production efficiency.

Chart 17: Ezz Steel’s Liquidity and Leverage



Source: Bloomberg

Chart 18: Ezz Steel’s Liquidity and Leverage



Source: Company Reports, ASIB estimates

One major issue however arises, concerning the reluctance of financial intermediaries to provide liquidity for Ezz Steel beyond current obligations. This would most likely occur with its major shareholder Ahmad Ezz being indicted for corruption.

ACQUISITION: A POTENTIAL VALUE BOOSTER FOR EZZ STEEL

One solution to Ezz Steel’s liquidity problems would be a court ruling forcing Ahmad Ezz to sell all his shares in the company. Ezz Steel would then no longer be related to its previous owner and financial institutions would be willing again to offer liquidity. Another attractive solution is the potential acquisition of Ezz Steel by a third party. This will provide the Egyptian steel maker with a liquidity boost to finance expansion projects and working capital.

The effect of a potential takeover would reflect on Ezz Steel’s share price as follows:

Estimated fair value	in EGP
Target price	13.39
Assumed acquisition premium range	20% - 25%
Estimated fair value range (in EGP)	16.07 - 16.74

FINANCIAL STATEMENTS

Consolidated Income Statement

In EGP mn	2011	2012e	2013e	2014e	2015e	2016e
Net Sales	18,611	20,773	24,288	24,903	26,514	27,921
Cost of goods sold	(16,404)	(18,520)	(21,459)	(21,867)	(23,068)	(24,182)
Gross Profit	2,207	2,252	2,829	3,036	3,447	3,738
<i>Gross profit margin</i>	<i>11.9%</i>	<i>10.8%</i>	<i>11.6%</i>	<i>12.2%</i>	<i>13.0%</i>	<i>13.4%</i>
Selling and marketing expenses	(113)	(104)	(170)	(149)	(159)	(195)
General and Administrative expenses	(297)	(332)	(389)	(398)	(424)	(447)
Impairment loss on assets	(17)	-	-	-	-	-
expenses for acquisition of DRI licenses	-	-	(119)	-	(135)	(135)
Provisions	(82)	(80)	(80)	(80)	(80)	(80)
Operating income	1,698	1,736	2,071	2,408	2,649	2,882
<i>Operating profit margin (%)</i>	<i>9.1%</i>	<i>8.4%</i>	<i>8.5%</i>	<i>9.7%</i>	<i>10.0%</i>	<i>10.3%</i>
Finance expenses	(764)	(823)	(805)	(802)	(805)	(814)
Interest income	64	56	65	66	66	64
Other expenses	(22)	(2)	-	-	-	-
Net finance costs	(722)	(770)	(741)	(735)	(739)	(750)
Other Revenue	52	60	90	110	120	130
Total other income	52	60	90	110	120	130
Net profit before tax & non-controlling interest	1,028	1,026	1,421	1,782	2,030	2,262
Income Tax	(359)	(341)	(425)	(446)	(507)	(565)
Deferred tax	(133)	(72)	(99)	(125)	(142)	(158)
Net profit before minority interest	536	614	896	1,212	1,380	1,538
Minority interest	(334)	(344)	(493)	(654)	(732)	(800)
Net profit attributed to equity holders	202	270	403	558	649	738
<i>Net profit margin (%)</i>	<i>1.1%</i>	<i>1.3%</i>	<i>1.7%</i>	<i>2.2%</i>	<i>2.4%</i>	<i>2.6%</i>

Consolidated Balance Sheet

In EGP mn	2011	2012e	2013e	2014e	2015e	2016e
property, plant and equipment	9,937	10,434	10,956	11,503	11,848	12,204
Projects under construction	3,558	3,629	3,811	4,001	4,121	4,245
Prepaid investment	110	110	110	110	110	110
Long term lending	5	5	5	5	5	5
Prepaid taxes on sales	165	165	165	165	165	165
Goodwill	315	315	315	315	315	315
Total Non-Current Assets	14,090	14,658	15,361	16,100	16,565	17,044
Inventories	3,628	3,531	3,522	3,486	3,447	3,350
Trade and notes receivable	122	208	243	249	265	279
Debtors and other debit balances	628	727	850	872	928	977
Advances to suppliers	135	145	170	174	186	195
Investments in treasury bills	63	63	63	63	63	63
Cash and cash equivalents	1,171	1,329	1,554	1,594	1,591	1,536
Total Current Assets	5,747	6,004	6,402	6,438	6,479	6,401
Total Assets	19,837	20,662	21,763	22,538	23,044	23,445
Loans	3,937	3,635	3,983	4,109	4,242	4,411
Other non-current liabilities	238	240	243	245	248	250
Bonds loan	433	213	-	-	-	-
deferred tax liabilities	791	712	676	663	669	676
Total non - current liabilities	5,399	4,800	4,902	5,017	5,159	5,338
Banks credit accounts and overdrafts	999	1,039	1,020	1,021	1,008	838
Short term loans and borrowings	3,577	3,843	3,935	4,084	4,110	4,328
Bonds loan	220	220	213	-	-	-
Trade and notes payable	1,364	1,413	1,627	1,668	1,750	1,815
Advances from customers	236	270	316	324	345	363
Creditors and other credit balances	1,177	1,246	1,457	1,494	1,591	1,675
Provisions	204	200	660	528	396	264
Total Current Liabilities	7,777	8,231	9,228	9,119	9,199	9,282
Issued and paid in Capital	2,716	2,716	2,716	2,716	2,716	2,717
Reserves	3,961	3,975	3,995	4,023	4,055	4,092
Retained earnings	1,438	2,301	1,966	2,621	2,813	2,808
Net Profit for the year	202	270	403	558	649	738
Treasury Stock	(71)	(71)	(71)	(71)	(71)	(71)
Translation difference adjustments	185	100	90	85	75	50
Difference Resulting from Acquisition of subsidiaries within the group (EZDK)	(3,600)	(3,600)	(3,600)	(3,600)	(3,600)	(3,600)
Total shareholder Equity	4,831	5,691	5,499	6,332	6,637	6,735
Non-controlling	1,830	1,940	2,134	2,071	2,049	2,090
Shareholders' Equity	6,661	7,631	7,633	8,401	8,686	8,825
Total Liabilities & Equity	19,837	20,662	21,763	22,538	23,044	23,445

