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Kinsteel Berhad's Acquisition of Perwaja Steel Sdn Bhd

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A Case Study on the Kinsteel Berhad's Acquisition of Perwaja Steel Sdn Bhd

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Perwaja: From Scrap Metal to Gleaming Steel … Or Is It?

Can a company portrayed as a hopeless investment for the past 20-odd years be turned around within a couple of years in the hands of private shareholders? Indeed, the 30-year history of Perwaja is full of controversies with mismanagement, allegations of criminal breach of trust, misguided corporate strategies and failed turnarounds.

Perwaja was one of the Government's initiatives under the First Industrial Master Plan to promote the development of heavy industries in Malaysia. In 1982, Perwaja Terengganu Sdn Bhd (PTSB) was incorporated as a Malaysian-Japanese joint venture with a paid-up capital of RM250 million. PTSB's major shareholders comprised of the Heavy Industries Corporation of Malaysia (HICOM), a Government agency for industrial development (with a 51% stake), a consortium of Japanese companies headed by Nippon Steel of Japan (30% stake) and the Terengganu State Government (19% stake). The steel project was also financed by a RM500 million loan from the Export-Import Bank of Japan.

Under a US$465 million turnkey contract, the Japanese parties undertook to build a direct-reduction plant and a billet-making plant in Kemaman, Terengganu. This plant was completed in August 1984. Perwaja's Kemaman plant is Malaysia's only billet-making factory that makes steel products through direct reduction of iron ore (DRI). Steel produced with DRI process is well known for its high content of iron ore and strength, and is ideal in ship-building and construction of bridges. During the initial years of its operations, Perwaja continuously lost money and was beset with problems triggered partly by external events such as the global recession of the mid-1980s, appreciation of the yen, decline in steel prices, and weak demand for steel. The difficulties faced by the company were further compounded by its own internal operating problems. Perwaja's plant was to run on a new direct reduction method that used natural gas to process iron ore into HBI, the feedstock for making high-grade billets. This method, developed by Nippon Steel, had worked in pilot projects in Japan in the 1970s but had never been used commercially. Nippon Steel was so confident that the new process would work that it agreed to pay Perwaja compensation should the process fail. After attempts to produce HBI of an acceptable standard at Perwaja failed, Nippon Steel had to compensate Perwaja more than RM500 million in 1987 and the direct-reduction plant was closed in 1987.

Question: Under what circumstances would a risk sharing and compensation clause be necessary for a joint-venture?

In 1988, the Government, frustrated with prevailing conditions at Perwaja, took control of the steel project and appointed Tan Sri Eric Chia from UMW Holdings Bhd to overhaul the ailing steel venture. In 1989, the Japanese shareholders gave up their 30% stake to the Malaysian Government for a nominal sum of RM1 and in the following year, a major restructuring of the company took place. Under the restructuring plan implemented in 1990, PTSB transferred all its assets and operations to Perwaja Steel Sdn Bhd, a wholly-owned subsidiary incorporated to take over the manufacturing operations, which in turn received a

RM250 million capital injection from the Government. Debts outstanding amounting to about RM1.2 billion were, however, retained by the parent company.

Although Perwaja was already saddled with RM1.2 billion in liabilities then, Tan Sri Eric Chia proceeded with an aggressive plan in the early 1990s to revive and expand its operations at a cost of billions of ringgit, financed mainly by borrowings. These investments gave Perwaja its present form, including the rolling mill, and beam and section mill in Gurun, Kedah. The Gurun factory makes steel bars, wire rods, beams, sections, bolts and nuts, nails and wire meshes.

Despite the changes in management and new strategies, things still did not work out for Perwaja. Between 1985 and 1994, Perwaja had accumulated over RM2.5 billion in debt and losses, according to news reports. The company found itself in an insolvent state, and the Government appointed Price Waterhouse, an audit firm, to perform an overall audit of Perwaja. In August 1995, Tan Sri Eric Chia abruptly resigned. He was later charged[1] with misappropriating RM76.4 million from one of Perwaja's subsidiaries in 1994.

Since its early years, Perwaja had been embroiled in many controversies including a long list of alleged management irregularities[2]. These were said to be:

- Payment of US$27.1 million to a mysterious company in Hong Kong;
- Misuse of proceeds from a US$196 million loan;
- Purchase of parts of questionable quality which were not used by the company;

[1] Tan Sri Eric Chia was charged under Section 409 of the Penal Code which carries a jail term of between two and 20 years and whipping, and a fine upon conviction. In June 2007, Tan Sri Eric Chia was acquitted by the Kuala Lumpur Sessions Court of misappropriating RM76.4mil from Perwaja Rolling Mill and Development Sdn Bhd in his capacity as its managing director on 19 February 1994. He was also acquitted of an alternative charge of dishonestly disposing of Perwaja's funds by entering into an agreement with NKK Corporation, Japan, and authorising RM76.4mil to be paid into the account of Frilsham Enterprise Inc with the American Express Bank Ltd, Hong Kong without the approval of the Board of Directors of Perwaja Rolling Mill and Development Sdn Bhd. The judge had ruled that the prosecution had failed to establish a prima facie case against Tan Sri Eric Chia.

[2] The financial crisis in mid-1997, underlined by a number of corporate failures partly attributed to mismanagement and poor governance such as in the case of Perwaja, exposed the poor state of corporate governance in corporate Malaysia then. This prompted the Government, in March 1998, to establish a high level Finance Committee on Corporate Governance (FCCG) to comprehensively review corporate governance practices in the country and to recommend law reforms to strengthen its effectiveness. Members of FCCG comprised of senior representatives from the Government, regulatory agencies, industry bodies and professional associations and their recommendations were partly based on the findings of a survey conducted concurrently by the Kuala Lumpur Stock Exchange (KLSE) and PricewaterhouseCoopers (PwC) on corporate governance practices of Malaysian public listed companies. The timely announcement and effort underscored the crucial need to boost investors' confidence and for companies to exhibit greater transparency and accountability through enhanced standards of corporate governance. The Committee identified five weaknesses in the governance practices of Malaysian listed companies, namely, ownership concentration, limited role of independent non-executive directors, shareholders passivity, lack of awareness of responsibilities by directors and lack of enforcement of good practice. Based on these findings, the Committee subsequently issued a proposed Malaysian Code on Corporate Governance (MCCG) in February 1999, which was later formalised in March 2000.

- Contracting the services of a local company for gardening, cleaning and vehicle maintenance at a cost of almost RM200,000 per month;

- Awarding construction contracts worth RM529 million to Man Shoon Group of companies, controlled by a long-time associate of Tan Sri Eric Chia without asking for competitive bids or referring the deals to Perwaja's tender committee;

- Contract to pay Tomen, a Japanese firm, commission at the rate of US$3 per metric ton of ore purchased when the typical commission internationally was about US$0.75 per ton; and

- Engaging a Singaporean commodity trading firm to market Perwaja's direct-reduced products at a shipment price of US$112 per ton at a time when the quoted market price was US$150 per ton.

Tan Sri Eric Chia's departure left a management vacuum in Perwaja for several months between 1995 and 1996. In 1996, the Ministry of Finance temporarily took control of the operations of Perwaja until the Government decided not to pick another trouble shooter to run the steel project. Instead, it announced its plan to privatise Perwaja.

Given that the Government believed the steel industry is a main driver of economic growth and development and had high potential, it considered several alternatives to turn around Perwaja, including privatising the company. In 1997, PTSB, which was controlled by the Government, and as the direct holding company of Perwaja, sold its entire interests in the steel project to Equal Concept Sdn Bhd for RM2 billion by way of issuance of two billion shares of RM1 each in Equal Concept to PTSB. This exercise was completed in 1999.

When the Government announced its intention to privatise Perwaja, several parties showed interest. These included the Lion Group, Wing Tiek Holdings Bhd (now JAKS Resources Bhd) and Maju Group. It was said that Tan Sri William Cheng of the Lion Group was willing to take over Perwaja's operations at that time for as much as RM2 billion. At the time, there was no Mega Steel which only commenced operations in 2001. But while the Lion Group may had seemed the most qualified then, it did not land Perwaja, which ended up with Maju instead which was controlled by Tan Sri Abu Sahid Mohd. Maju Group is one of Malaysia’s largest private companies and is a diversified group with a presence in five core businesses providing products and services in industries as diverse as construction, property, infrastructure, services and manufacturing. However, it was not until January 2003 that Maju Group finally acquired the entire interest in Equal Concept from PTSB, but for a much smaller consideration of RM500 million and with the assumption of liabilities of RM805 million. Even the bulk of the RM500 million purchase consideration was to be paid in instalments. Between 1996 and 2003, before Maju officially took over the Perwaja operations, it was managing Perwaja on behalf of the Government.

However, Perwaja Steel, the holding company for the Kemaman upstream operations, continued to bleed between 2001 and 2005. There was, however, a huge debt waiver of RM2.67 billion granted to PTSB in 2003, which temporarily bumped up Perwaja Steel's profit. Losses for the financial years ended 31 March 2001 and 2002 were RM310.75 million and

RM264.42 million respectively. For the financial year ended 2003, Perwaja Steel reported a net profit of RM2.07 billion due to the debt waiver. For the financial year ended 31 December 2004, there was a net profit of RM45.76 million. But for the financial year ended 2005, the company again reported a loss of RM103.13 million, due to an increase in raw material costs as well as the write-off of bad debts and equipment.

On 7 October 2005, it was announced that there would yet be the entry of another new shareholder in Perwaja. In the announcement, Kinsteel[3] would acquire a 51% stake in Perwaja from Maju's wholly-owned subsidiary, Equal Concept Sdn Bhd, for RM197.6 million to be satisfied by 60 million new Kinsteel shares at RM1.36[4] each and the balance of RM116 million in 68 monthly cash payments. Kinsteel would also set up a new subsidiary to acquire a 51% stake in Perfect Channel Sdn Bhd, the company that owns the Gurun plant, from Maju, to be settled via RM100 million cash and new shares. Perwaja's debts of RM786 million would be assumed by the Kinsteel-Maju alliance. Hence, in total, Kinsteel paid almost RM300 million in the exercise which saw Maju retaining a 49% stake in Perwaja and the Gurun assets. Maju and Kinsteel had announced that they were forming a conditional alliance to manage Perwaja with plants in Kemaman, Terengganu, and Gurun, Kedah. The purchase consideration was arrived at based on a willing buyer-willing seller basis after taking into consideration, amongst others, the market price, earnings, prospects and adjusted audited net tangible assets per share of the Kinsteel Group at RM1.74 as at 31 December 2004.

Pursuant to this acquisition exercise, Kinsteel also sought, and obtained, the approval of the Securities Commission to the following:

(i) exemption under Practice Note 2.9.1 of the Malaysian Code on Takeovers and Mergers, 1998 to Equal Concept Sdn Bhd and persons acting in concert from the obligation to undertake a mandatory offer for the remaining Kinsteel shares not held by them upon completion of the exercise[5];
(ii) exemption under Practice Note 2.9.6 of the Malaysian Code on Takeovers and Mergers, 1998 to the vendors of Gurun assets from the obligation to undertake a mandatory offer for the remaining Perfect Channel Sdn Bhd shares not held by it upon completion of the exercise; and

[3] Kinsteel is principally involved in investment holding, manufacturing and trading of steel bars and related products. The immediate holding company of the Group is Kin Kee Holdings Sdn Bhd and the ultimate holding company of the Group is Perniagaan Kin Kee Sdn Bhd, both of which are incorporated in Malaysia. The company is a public limited liability company, incorporated and domiciled in Malaysia, and listed on the Main Board of the Bursa Malaysia Securities Berhad.

[4] The issue price of RM1.36 per Kinsteel share represented a premium of RM0.32 or 30.8% over the 5-day weighted average market price of Kinsteel up to and including 6 October 2005 (being the last full trading day of Kinsteel shares prior to announcement of the strategic alliance the next day) of RM1.04.

[5] As this involved a public listed company, the approval of the Securities Commission was accordingly obtained on the conditions that (i) the approval for exemption is obtained from the independent shareholders of Kinsteel on a poll in general meeting in which the interested parties abstain from voting, and that the results of the poll by confirmed by an independent auditor; and (ii) provision is made for the shareholders of Kinsteel for competent independent advice regarding the proposed exemption. Further, the appointments of the independent adviser and the independent adviser's circular to shareholders must be first approved and consented to by the Securities Commission respectively.

(iii) exemption under Practice Note 2.9.6 of the Malaysian Code on Takeovers and Mergers, 1998 to Kinsteel from the obligation to undertake a mandatory offer for the remaining Perwaja Steel Sdn Bhd shares not held by it upon completion of the exercise.

From Kinsteel's viewpoint, this strategic alliance would enable it to further strengthen its presence in the steel industry by transforming itself into one of the largest integrated steel manufacturers in the country through upstream (manufacturing of DRI and billets), midstream (manufacturing of H-beams and I-beams) and downstream (manufacturing of wire rod, wire mesh, wire conditioning and nails) diversification. Being a fully integrated steel player would enable it to better manage its supply chain and increase its competitiveness. The strategic alliance would also provide Kinsteel with a platform to expand its product range and increase its market penetration both locally and overseas. With this strategic alliance, Kinsteel would also be able to further consolidate its niche position by becoming the only H-beam and I-beam manufacturer in the country.

Detailed information on the strategic alliance agreement is elaborated in Kinsteel's letter to shareholders, attached as **Exhibit 1.**

This alliance was met with a degree of scepticism by the market. "The first impression is, Maju is dumping Perwaja," said a senior analyst at a local brokerage. Another analyst from a local research house concurred with the view. By selling the controlling stake in Perwaja, it looked like Maju did not want to be solely responsible for the steel company anymore after some nine years[6], he added. Analysts were of the view that the RM297.6 million price tag for the deal was on the "cheap" side. "It will take more than RM300 million to set up the kind of steel manufacturing facilities that Perwaja has. It's hard to say right now whether Kinsteel got a good deal because Perwaja is saddled with huge debts".

An independent advice circular written by PM Securities Sdn Bhd [7] to provide an independent evaluation and recommendation on the strategic alliance is as attached as **Exhibit 2**.

Maju, on the other hand, reiterated that it was not exiting Perwaja but expected the alliance to be a boost to the country's largest steel producer. "Maju has no plans to reduce its stake in Perwaja," its executive chairman Tan Sri Abu Sahid Mohamed had said. "Maju wishes to reiterate that it continues to be fully committed towards the growth and future of Perwaja since it took over the company in 1996." "This alliance is consistent with Maju's business plan proposed to the Government in 1999 after it took over Perwaja in 1996, that the entry of a strategic partner into the equation is crucial in elevating the company to a higher level. Kinsteel, with its strengths in midstream activities, presents the best synergistic strengths to boost Perwaja, which is already a well-established player in upstream production activities. The way forward for the industry players is to aggressively venture into integrated activities. This alliance allows us to do just that." "The steel sector is marked by cyclical trends and growth, and while the sector may be facing challenges, the local steel industry has to build downstream capabilities to better serve the domestic market and compete effectively in the

[6] Maju's takeover of Perwaja: 1996; Kinsteel's takeover of Perwaja: 2005.

[7] Independent adviser appointed by the Board of Kinsteel Berhad.

international arena." He also said the consolidation of the industry via mergers and acquisition was in line with the Government's policy towards the rationalisation of the steel industry.

Note:
Exhibit 3 illustrates Kinsteel Berhad's Corporate Structure as at end 2006 after their 51% acquisition of Perwaja.

Question:

i. *Do you agree with the viewpoints made by Maju?*
ii. *Do you think it was a good deal for Maju, Kinsteel and Perwaja, and why?*

Fifth Time Lucky …

But things did take a turn for the better for Perwaja since Kinsteel, controlled by Tan Sri Pheng Yin Huah, took the helm. In 2007, for the first time in its 25-year history, the Kemaman plant ran at full capacity and turned in decent profits. The turnaround of Perwaja finally looked real. It silenced its critics and fund managers began to buy into its story, as reflected in the euphoric share price appreciation of its 51% owner, Kinsteel Bhd, as shown in **Figure 1**.

Figure 1. Last Prices of Kinsteel Berhad (January 2005-September 2007)
Source: Bloomberg

Kinsteel is the fifth owner-cum-manager of Perwaja. Kinsteel is majority-owned by the family of Tan Sri Pheng Yin Huah, a veteran steel player who had a humble beginning as a scrap metal collector in Kuantan.

Prior to entering into the alliance with Maju, Kinsteel itself made a rights issue involving the issuance of up to 50 million new shares of RM1 each at an issue price of RM1.36 each. Of the 50 million shares, its shareholders subscribed for about 89% or 44 million shares, while the unsubscribed portion was taken up by the underwriter. The exercise was completed on May 31, 2005[8].

Through the alliance, Maju walked away with a good deal, having retained a 49% stake in Perwaja operations and was in a happy position as the 60 million Kinsteel shares it held,

[8] The diversion of funds from the rights issue for another purpose following the Perwaja takeover was not without controversy. Kinsteel shareholders had no say in the utilisation of the proceeds from the rights issuance. It was commented that the minority shareholders of Kinsteel may not have an avenue to voice their grievances regarding the company's decision because, "as the proceeds from the rights issue are to be utilised for the purchase of plant equipment/machinery for Kinsteel's core business, the approval of the Securities Commission and the approval of the shareholders for the above variation will not be required", said the company in an announcement. However, it was noted that the minority shareholders who took up the rights shares would have done so with the view that the money would be used for a billet plant that would boost Kinsteel's earnings in the future, and in turn enhance the value of its shares.

On the one hand, Kinsteel's decision to scrap its plans to build a steel billet plant made sense as it was acquiring a 51% stake in Perwaja and would, in turn, have access to the latter's steel billet plant. Hence, there was no necessity to build another steel billet plant. However, Kinsteel's decision to spend the RM68 million originally intended for the steel billet plant to build a wire-rod plant instead, baffled investors. The plan was frowned upon for several reasons. Firstly, Perwaja already had a dormant wire-rod plant in Gurun. "Why not revive the dormant wire-rod plant?" Industry players found it hard to comprehend Kinsteel's decision to spend another RM68 million to build a wire-rod plant when it was proposing to pay RM297 million for a 51% stake in Perwaja. For a company with a share capital of RM110 million, the amount it intended to spend to build the wire rod plant is significant. Kinsteel managing director Datuk Pheng Yin Huah said the company's proposed acquisition of Perwaja had put its plan to build a steel billet plant on the back burner. "With the proposed acquisition of Perwaja, which has a billet manufacturing capacity of 1.3 million tonnes per annum, Kinsteel has effectively acquired a much larger billet plant, and hence does not need to construct its own billet plant," he said. Datuk Pheng said Kinsteel's plan to build a wire-rod plant was not new and it had kept the market informed of this plan from its inception. "As the capital expenditure for the wire-rod plant had already been committed to, Kinsteel decided to vary the utilisation of the proceeds from its rights issue towards the purchase of plant and machinery for the wire-rod plant," he said.

On why Kinsteel needed to build another wire-rod plant despite Perwaja's dormant plant, Datuk Pheng said the two plants would complement each other as they catered for different markets. Added Datuk Pheng, its wire-rod plant would have a production capacity of 300,000 tonnes per year and would be able to produce rods in 2.2-tonne bundles instead of the conventional one-tonne bundle. Kinsteel's plant would produce special-grade wire rod, an item not controlled by the Government. It would also be capable of producing other types of steel products such as structure bars and long steel products. The combined production capacity of Kinsteel's and Perwaja's wire-rod plants would be 750,000 tonnes per annum. Datuk Pheng said with Perwaja's billet plant, Kinsteel would have a constant supply of billets and would be able to "reduce the working capital requirements of Kinsteel as it would be able to reduce its stockholdings of billets through better supply chain management". With Perwaja under its wing, Kinsteel would become one of the largest integrated steel players in Malaysia, with upstream, midstream and downstream operations. "Being a fully integrated player will boost Kinsteel Group's operating efficiencies through the synergies, supply chain management and combined marketing of its whole range of products," he said.

representing 34.94% of the company, issued at RM1.36 per share had appreciated significantly to around RM4 in 2007[9].

"Abu Sahid and I are old friends. We know that to expand Kinsteel or Perwaja, we need to form alliances with one another. Although Maju had other proposals from local players or from abroad, it finally settled on us. It is a good fit because Kinsteel buys raw materials from Perwaja and our plant in Kuantan is near Perwaja's upstream facilities in Kemaman," says Tan Sri Pheng.

Kinsteel's shareholders too had little to complain about. Before the Perwaja deal, its market capitalisation was about RM100 million. By 2007, it was worth about RM700 million, an appreciation of RM600 million. Stripping out the RM300 million that it paid for the 51% in Perwaja, Kinsteel's shareholders had Perwaja for "free", based on market prices.

However, the market value would be sustainable only if Perwaja continued on its recovery track and improved. Until 2008, the Phengs (father and son) had done well in turning it around. But what is so different now compared to the previous management which had often claimed that Perwaja could not be saved?

In contrast with Kinsteel, Perwaja's aim was to position itself as an integrated producer of high-quality DRI and semi-finished long steel products for the global market. Its marketing strategies included (a) positioning itself as an established producer with a long track record; (b) ensuring that all products were of high quality, met with customer specifications, and delivered on schedule; (c) continuously carrying out research and development to diversify its range of semi-finished long steel products to meet customer needs; and (d) keeping abreast of developments in the primary steel products industry to better meet customer needs and stay ahead of the competition.

Table 1. Percentage of Sales Revenue of Perwaja's Major Customers

Customer	*2005*	*2006*	*2007*
Kinsteel Bhd	24.5	42.9	31.9
Megasteel Sdn Bhd	1.5	1.1	2.6
Southern Steel Bhd	14.2	10.1	4.5
Daewoo International Corporation	5.4	–	2.0
Perfect Channel Sdn Bhd	–	8.0	20.8
Cargill International Trading Pte Ltd	–	1.2	17.5

Source: Perwaja Holdings Berhad Prospectus

[9] Indeed, Maju realised its gains from the appreciation in the share price of 2.46 million Kinsteel shares at between RM3.88 and RM3.90 in 2007.

With the steep appreciation in the share price of Kinsteel, the company had, in 2007, proposed a share split involving the subdivision of every 1 existing share of par value RM1.00 held by Kinsteel shareholders into 5 subdivided shares of par value RM0.20 each. The new ordinary shares so created will be listed on the Main Board of Bursa Securities and will rank pari passu with the existing shares.

Kinsteel expected the share split to enhance the liquidity and marketability of its shares as a result of the increased number of shares in issue. The approval of the SC to this exercise was obtained on 27 August 2007 and the share split exercise was completed in the fourth quarter of 2007.

Table 2. Sales Revenue of Perwaja by Geographic Sector (in RM'000)

Market Sector	*2005*	*2006*	*2007*
Domestic	781,912	1,043,389	1,390,623
Overseas	280,660	138,703	302,384
Total	1,062,572	1,182,092	1,693,007

Source: Perwaja Holdings Berhad Prospectus

Question:

i. *What do you think of Perwaja's strategy compared to Kinsteel's strategy for the company?*
ii. *Was Perwaja's strategy partly to blame for its losses and was Kinsteel's strategy critical to Perwaja's turnaround?*

Perwaja's past management had contended that the steel maker could not be managed profitably mainly because the upstream (Kemaman plant) and downstream (Gurun plant) operations were too far apart. It took 12 hours for each trailer, loaded with about 15 tonnes of steel billets, beam blanks and blooms, to travel from Kemaman in Terengganu to Gurun in Kedah.

Each day, about 80 trailers would leave Kemaman for Gurun. As the trailers could not take the hilly roads up north linking Kemaman and Gurun, they had to go down to Kuala Lumpur first instead, then travel up north to Gurun again. The transport costs alone between Kemaman and Gurun came up to RM1.5 million per month, or RM18 million a year.

"It is true that logistical problems are costing us a lot. But they are somewhat mitigated by the location of the upstream facilities in Kemaman next to the port. The ships offload the iron ore which is the raw material to make DRI at the port and the conveyor belt moves the load to our DRI plant, 1.5km away. The tremendous cost savings make up for the high logistical costs incurred between Kemaman and Gurun," said Henry Pheng, the son of Datuk Pheng, who manages the operations on a daily basis.

More importantly, the timing was perfect for Kinsteel when it acquired Perwaja. Demand for DRI and steel billets had picked up strongly in the second quarter 2006.[10] By having the upstream facilities running at full capacity, it helped defray the production costs in the entire group. This was one of the main reasons for the strong profit. In addition, higher selling prices had contributed significantly to the earnings.

[10] As illustrated in the global prices of various steel products from 2005 to 2007 shown in **Figure 2**.

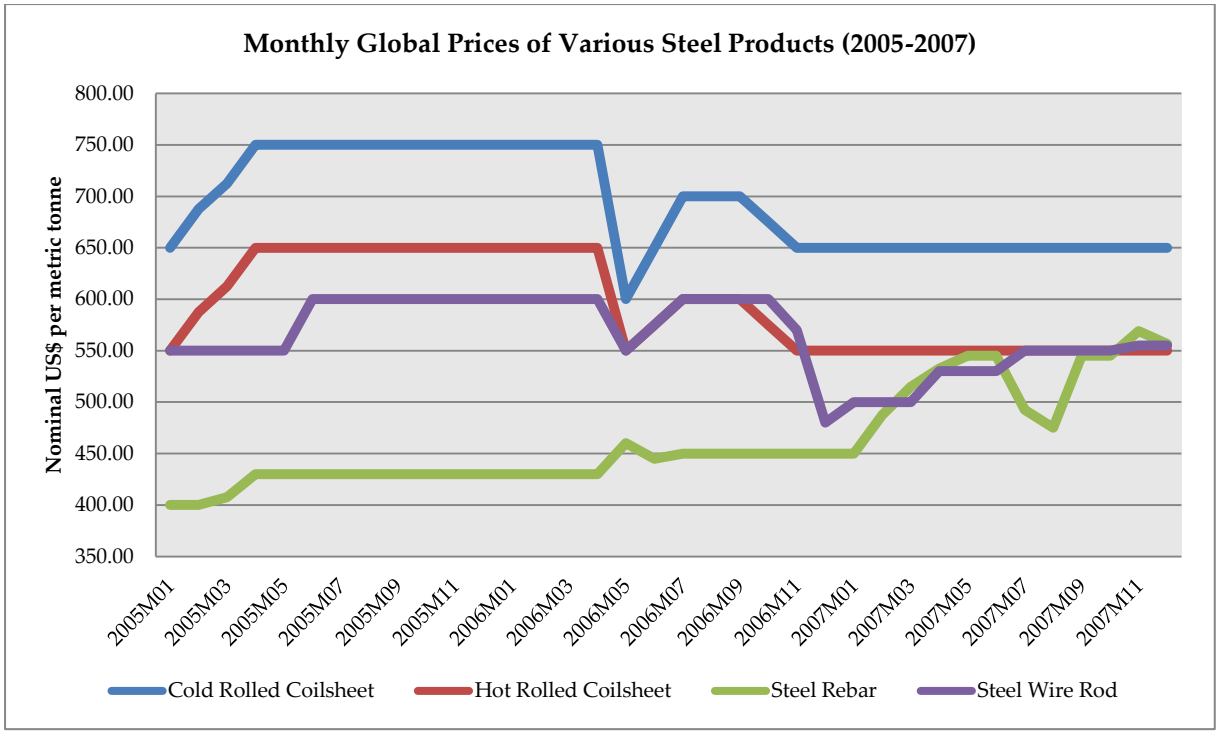

Figure 2. Monthly Global Prices of Various Steel Products (2005-2007)
Source: Global Economic Monitor, World Bank

A Swift Turnaround …

Perwaja owed its turnaround to the robust operating environment, driven by record-high steel prices and the seemingly insatiable demand. Credit was also given to the new major shareholder who knows the steel industry and business inside out. Being a strategic part of the Kinsteel Group of Companies, it was able to leverage on their respective strengths and collectively participate in a substantial part of the entire steel value chain as a fully integrated steel producer.

It was reported that Perwaja made earnings before taxes of RM96.46 million for the financial year ended 2006. This was achieved immediately a year after its acquisition by Kinsteel as compared to 2005, where Perwaja had lost RM103.13 million from its Kemaman plant operations. It, however, posted a net profit of RM45.76 million in financial year 2004. The steel mills in Gurun, now under Perfect Channel, were not operating for the past few years until early in 2006.

But it is obvious that the key difference lies in the capacity utilisation rates. Despite its mammoth capacity, the potential of Perwaja was never fully tapped. The demand was either not there or it was economically less viable to sustain activities at the optimum level because of the high logistical costs and the historically low steel prices. In addition, previous management could not raise sufficient working capital to run at full capacity, according to industry sources.

"When we first came in October 2005, the Kemaman plant was running at 50% capacity; now it is running at full capacity. For Gurun, the mills were not running when we went in, now we are running at about 30%," said Henry Pheng. The Kemaman facilities had 2,000 workers

then. The former was capable of producing 1.2 million tonnes of DRI, while the latter could produce 1.3 million tonnes of steel billets, beam-blanks and blooms annually. In Gurun, the bar and wire-rod mill had an annual capacity of 500,000 tonnes, whereas the beam and section mill had an annual capacity of 700,000 tonnes. There were about 500 workers in Gurun. With operations running at full capacity, the Gurun facilities could maximise its source of key raw materials for steel billets, beam-blanks and blooms which came from Kemaman to produce downstream products such as steel bars, wire rods, beams and sections.

The Kemaman plant was expected to continue running at full capacity, while for the Gurun plant, capacity utilisation rate was targeted to rise from 30% to 40% in 2007. "We are modifying our machines in Gurun. At present, we cannot produce in full. Most of our machines are mainly designed for the metric system, but in Malaysia most people are using the imperial system. So, it will take at least two years for us to fully convert to the imperial system," said Henry Pheng. "Moreover, our machines in Gurun were supposed to produce steel products of up to 30 specifications, but all this while we have been making only 12 specifications. Therefore, we are aiming to produce the full categories of specifications to get a bigger market share," said Henry Pheng.

Besides reactivating the Gurun mill, Kinsteel also set up a wire rod mill in Gebeng. Wire rods are mainly processed into building materials such as nuts and bolts. The move was criticised because competition in that market is intense and besides, Perwaja's Gurun mill already makes wire rods. However, Kinsteel maintained that it had already planned to set up a wire rod mill as early as in 2004. The new wire rod mill in Gebeng, which can produce 300,000 tonnes a year, will be the fourth in Malaysia. Existing wire rod producers are Amsteel Corp Bhd, Southern Steel Bhd and Malayawata Steel Bhd. Henry Pheng said the local demand for wire rods would strengthen due to new construction projects to be announced under the Ninth Malaysia Plan. The Perwaja-Kinsteel alliance, however, had changed one of Kinsteel's original plans to build its own billet plant. "Through this strategic alliance with Perwaja, Kinsteel doesn't need to build its own billet plant anymore. Instead, the billets will be sourced from Perwaja's DRI factory in Kemaman," Henry Pheng said.

As long as demand and prices for DRI and billets remain high, and with the upstream operations in Kemaman running at full capacity, the Phengs were confident of improving the capacity utilisation rate at Gurun.

"For them, now is the golden opportunity to turn Perwaja around. They bought it cheap, and at the right time, when they can make good profits from upstream activities and use the money to improve their downstream operations," said an industry player familiar with Kinsteel and Perwaja.

Due to strong demand and good prices for upstream products such as DRI, Kinsteel's immediate aim was to increase Perwaja's DRI annual production from 1.2 million to 1.5 million tonnes by the second half of 2007. While this required a few million ringgit of capital expenditure, it would enable Kinsteel to produce more DRI for exports.

"At present, of the 1.2 million tonnes of DRI produced in Kemaman, about 600,000 tonnes are for internal use (supplied to Kinsteel's mill in Kuantan and Perwaja's in Gurun). Another 300,000 tonnes are supplied to external clients such as Mega Steel Sdn Bhd and Southern Steel Bhd. So that leaves only 300,000 tonnes for export," said a steel analyst.

For Gurun, the strategy was not only to add capacity but to improve utilisation rate. Gurun would produce only higher-value products such as the H and I beams, high-grade steel bars and others. This was a wiser move due to the high transport costs between Kemaman and Gurun. The H and I beams, in particular, are rarely produced in Southeast Asia. So far, Perwaja is the only manufacturer of H and I beams in Malaysia and one of three players in Southeast Asia. Thus, Gurun would stop producing low-value products such as construction-grade steel bars. Production would instead move to Kinsteel's own rolling mill in Kuantan. This made sense since the Kuantan plant is near Perwaja's upstream facility in Kemaman and had a total annual capacity of 800,000 tonnes. "We see a lot of potential in Gurun as a standalone operation. Who knows, we may one day set up a separate melt shop in Gurun, so that it won't have to source the raw materials from Kemaman," said Henry Pheng. Though a lot needs to be done in Gurun, management expected it to be self-sustaining from 2007 onwards.

Kinsteel's long-term gearing of about RM683.49 million at that point in time was seen to be at a reasonable level. These long-term borrowings were mainly incurred due to consolidation of Perwaja's debts, of which about RM566 million were long-term liability. Of this, RM310 million comprised of 10-year medium-term notes (MTN) issued in 2006 to repay creditors and the remaining RM256 million would be repaid to the Government in seven years. "Based on our scale of operations, if we manage our production properly, the gearing shouldn't be a problem for us. We can digest this kind of borrowings," said Henry Pheng. A large portion of Perwaja's long-term liabilities were unpaid electricity bills to Tenaga Nasional Berhad (TNB). It is worth nothing that Perwaja had fully settled its RM320 million debt to TNB by November 2007. This was attributed to Kinsteel's successful efforts in increasing the overall capacity utilisation and improving the group's operational efficiencies and effectiveness which resulted in a strengthening of Perwaja's cashflows.

To A New Beginning…

And so in August 2008, Perwaja reached a new milestone in its history by making its debut on the Main Board of Bursa Malaysia Securities Berhad, under its holding company Perwaja Holdings Berhad. With the public listing, Kinsteel's interest in Perwaja was diluted from 51% to 37%[11]. At that time, an agreement was signed with the Finance Ministry for Perwaja to fully settle its remaining debts of RM250 million within 5 years. At an initial public offering (IPO) price of RM2.90, the Perwaja shares were over-subscribed by 189%. Kinsteel shareholders could subscribe to Perwaja at RM2.23 or a 23% discount, at the ratio of 1 Perwaja share for every 4 Kinsteel shares. At RM2.90, Perwaja was priced at just 4x 2009 earnings. Domestic long steel companies traded at 4.2x 2009 earnings, compared to regional

[11] Kinsteel, however, still holds 156m ICULs in Perwaja which would bring its stake in Perwaja back to 51% upon full conversion. The ICULs have a 10-year tenure and is important as its gradual conversion will dilute Perwaja's earnings in the future.

peers which traded at around 9x. Kinsteel itself traded at 5x 2009 earnings. The main reason for the huge discount was the lack of size and the probable restriction on exporting steel products by the Government.

A copy of the circular to Kinsteel's shareholders pertaining to the proposed listing of Perwaja Steel via Perwaja Holdings Berhad on the Main Board of Bursa Malaysia Securities Berhad is attached as **Exhibit 4**.

Question: Was the IPO price of Perwaja at a fair level?

Since then, however, the company's stock had traded at below its IPO price, reaching a low of RM0.60 in March 2009[12]. In mid-2009, the company reported net losses exceeding RM100 million for the first half of 2009 compared to profits of more than RM200 million for the same period in 2008. This was attributed partly to the decrease in steel demand and prices worldwide amidst the global recession. Henry Pheng told Reuters in an interview in March 2009 that the goal for the year was to ride out the recession by planning purchases carefully and taking other cost-saving measures rather than to make profits. Industry observers, however, questioned how much more market uncertainties the company could withstand and what strategic moves it would make to strengthen its market position and succeed in the competitive and volatile steel industry.

The steel industry was in a state of uncertainty in early 2009 as the global economic recession that started in 2007 intensified. The global crisis had led to a slowdown in the industries in which the steel industry depended (e.g. automobile and construction). Consequently, steel demand and prices declined, and many steel producers reduced production or stop production temporarily. Some steel producers were operating at less than 50% capacity and incurred losses in the first half of 2009. Those who had stocked up raw materials earlier at high prices now experienced a tight working capital situation and cash flow problems. The share prices of many steel companies listed[13] on Bursa Malaysia saw a sharp decline. The demand for steel of about 8 million metric tons in 2008 was expected to drop in 2009.

[12] Refer to **Figure 3**.

[13] The steel industry is dominated by a few public-listed companies such as Ann Joo Steel Berhad (formerly known as Malayawata Steel Bhd), Kinsteel Berhad, Malaysia Steel Works (KL) Berhad (MASTEEL), Perwaja Holdings Berhad, Southern Steel Berhad, and Lion Group. Lion Group, which owns a number of major steelmaking companies (e.g., Amsteel Mills Sdn Bhd, Antara Steel Mills Sdn Bhd, and Megasteel Sdn Bhd), is the largest steel producer in the country.

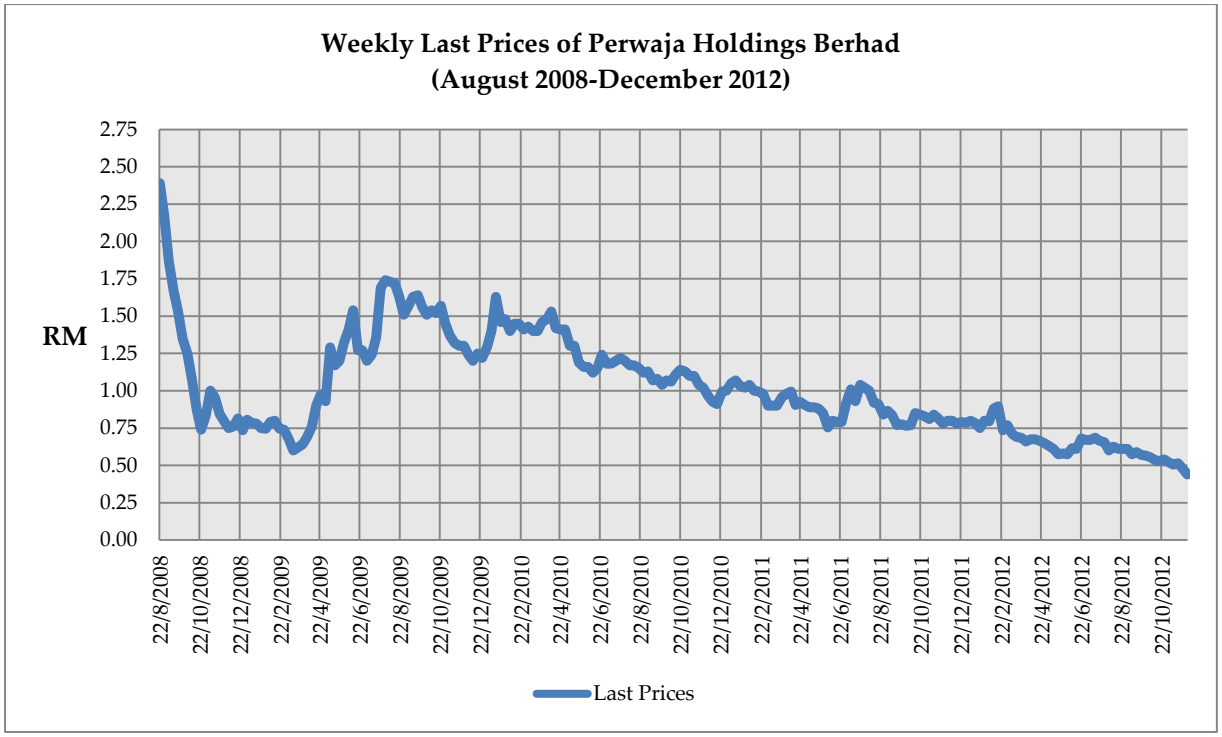

Figure 3. Last Prices of Perwaja Holdings Berhad (August 2008-December 2012)
Source: Bloomberg

Since 2009, Perwaja had once again fallen into the red[14]. By 31 March 2011, Perwaja's long term borrowings amounted to RM336.1 million and short term debts amounted to RM598.2 million[15]. However, its net cash flow from operations was in excess of RM50 million, indicating the operations are cash-flow positive. In the first quarter of 2012, Perwaja recorded a net profit of RM16.2 million on a turnover of RM406 million. According to the notes to the first quarter results, the concentrate and pelletizing plant, when commissioned, will significantly reduce the group's production cost and position its products at a more competitive price.

[14] Refer to **Figure 4**.

[15] According to the Auditor-General's Report 2011, Perwaja Terengganu has a debt of RM1.725 billion with the Federal Government, of which it had only repaid RM100 million. As at 2011, it still owed a total of RM1.625 billion due over 14 to 17 years. The report stated that the Federal Treasury will be making allocations to write-off the loan starting from 2011 and is expected to completely write it off by 2027. This has raised queries as Perwaja is a public listed company.

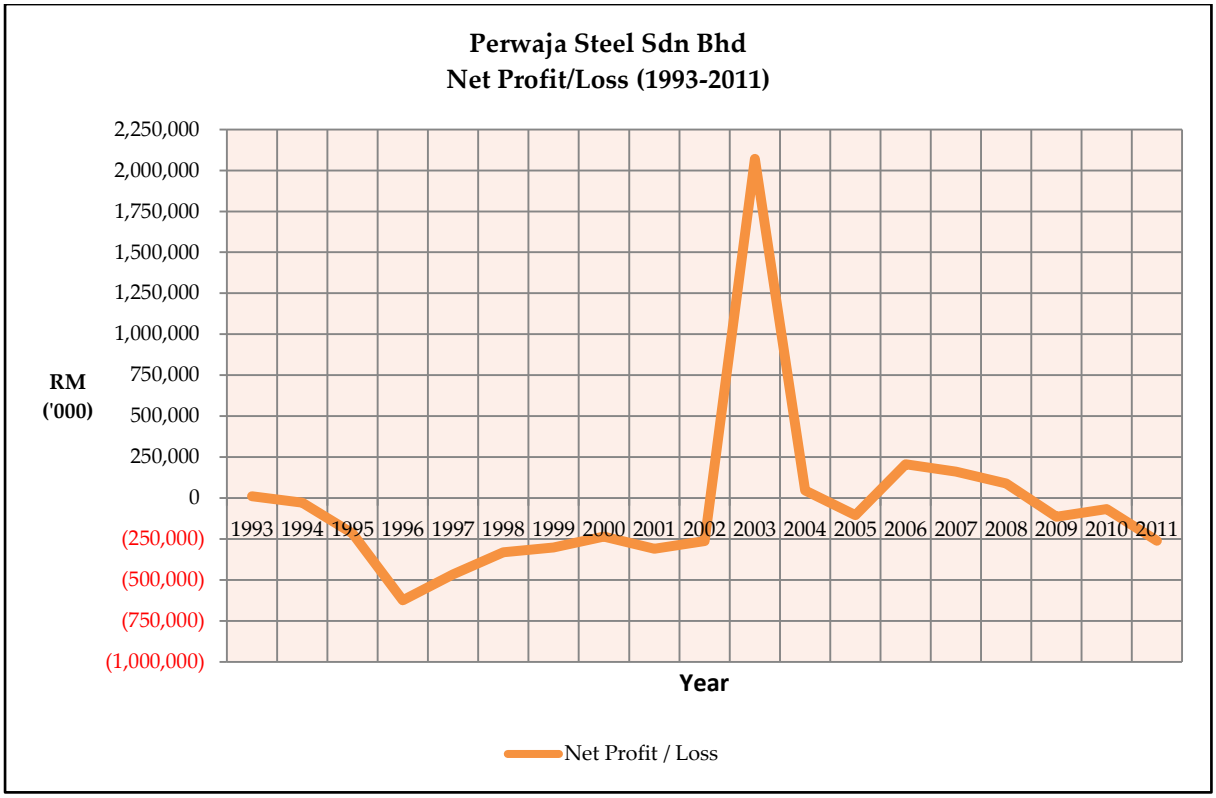

Figure 4. Net Profit/Loss of Perwaja Steel Sdn Bhd (1993-2011)
Source: Audited Annual Reports of Perwaja Steel Sdn Bhd[16]

If the strategy works and puts Perwaja on the path to profitability again, it will prove that locating a plant in Terengganu was the right decision because of the iron ore deposits. However, it will give rise to questions as to why Perwaja was not profitable when it was in the hands of the Government. Was it a fortuitous purchase by Kinsteel then, a good corporate strategy, right timing or all of the foregoing? However, it appears that the saga of Perwaja will still continue for some time ahead.

Looking Ahead to the Future …

For the country as a whole, Malaysia's 132 steel players must embark on mergers and acquisitions among themselves as well as with their regional counterparts to ensure their long-term survival and competitiveness. In July 2012, the Malaysian Iron and Steel Industry Federation president Datuk Soh Thian Lai said consolidation is the way to go as it will ensure a more efficient industry, greater economies of scale, good synergies, cost-savings, stronger bargaining power, firmer marketing activities and closer technical collaboration. "The industry has to merge due to an influx of steel products from China and India in the market and prepare for strong future growth, which is forecast at between three and five per cent this year." As an example, China alone produces 10 million tonnes of steel products a week, which is equivalent to Malaysia's annual production. The sheer size of China alone is daunting to the widely fragmented local industry which needs to beef up its own strength.

[16] With the completion of PTSB's restructuring exercise in January 2003, Perwaja Steel was discharged of its obligation to repay the amount due to PTSB of approximately RM2.149 billion and liabilities of approximately RM508 million owed to TNB and Petronas Gas Berhad as at 31 December 2001. Consequently, the waiver of liabilities amounting to RM2.657 billion was recognised as exceptional income during the financial year.

Malaysia has 10 big steel players such as the Lion Group, Perwaja and KYM. It also has some 50 midstream firms and the rest are smaller companies involved in trading and distribution and others. Melewar Industrial Group Bhd group managing director and chief executive officer Azlan Abdullah said since the last merger of Kinsteel and Perwaja, there has been no industry M&A. "Local companies should merge like Japan's Sumitomo and Nippon group - which is now the world's number two steel company."

He added that Malaysia - which is Asean's fourth largest steel producer after Thailand (14 million tonnes a year), Vietnam (11 million tonnes) and Indonesia (nine million tonnes) - needs to buck up before it falls in the ranking below the Philippines. Soh said that a commissioned study on enhancing the competitiveness of the iron and steel industry in Malaysia revealed that the steel sector must focus on three key areas: to provide advantaged access to selected raw materials, enforce trade remedies and standards, and enhance capabilities of overall industry.

Note:

- **Exhibit 5** explains MARC's downgrading of the rating on Perwaja's RM400 million MMTN Programme to A-ID.
- **Exhibit 6** provides a timeline of key events involving Kinsteel and Perwaja.

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