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EZZ Steel Company (ezzsteel)

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Rating Table:

Category	Current Rating	Previous Rating
Entity Rating: Senior Unsecured	BBB-	BBB-
Bond Rating: Senior Unsecured	BBB-	BBB-
Rating Outlook	Stable	Stable

Operating Statistics:

Figures in EGP mn	FY09	FY08	FY07	FY06
AROA (%)	2.4	15.8	12.5	16.1
AROE (%)	3.1	20.1	16.0	23.9
EBIT Margin (%)	4.3	0.9	5.3	6.5
EBITDA	245.4	122.3	281.1	286.8
EBITDA Margin (%)	6.0	2.1	6.9	8.4

Balance Sheet Statistics:

Figures in EGP mn	FY09	FY08	FY07	FY06
Turnover	4,112.7	5,950.2	4,092.5	3,414.4
Total Assets	10,141.9	10,526.5	8,045.8	7,218.7
Debt/EBITDA (x)	7.8	14.8	4.6	4.3
EBITDA/Interest Ex (x)	1.1	0.6	1.4	1.3

Opportunities/Strengths

- Leading position in the local market; with room to reserve its presence in regional/international markets through export activities once the global economic conditions recover.
- Solid reputation, associated with a well known brand.
- Current corporate structure enhancing the group's business profile and intensifying synergies.
- Despite the delay in the designed expansion plan; yet it is believed that once accomplished, will reflect positively on the group's overall performance in the medium to long term horizon.
- An owner/founder with a visionary approach supported by high caliber management team with good experience in the industry.

Risks/Weaknesses

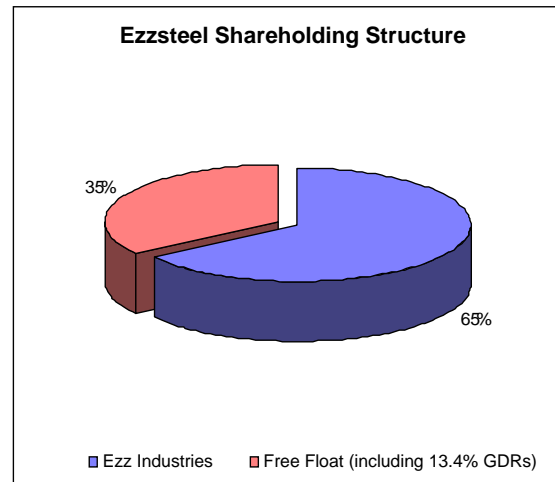
- The company on a stand-alone basis has reached almost full utilization capacity; however, the expansion plan at the group level will ease this challenge to a certain extent.
- The company's financial performance on a stand-alone basis is highly dependant on dividends received from subsidiaries, leaving the company's financial position vulnerable to any unpredicted events.
- The financial crisis shed pessimism on the global macro-economic environment; consequently might affect the local steel industry.
- High vulnerability to the volatility of international and domestic dynamics, which might adversely affect the overall mode of performance.
- The track record for the first bond issuance was not up to standard.
- Strong individual control, coupled by politicized issues around the chairman of the company, might negatively affect corporate governance fundamentals.
- High exposure to foreign exchange risk.

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Company Fundamentals

Ezz Steel Rebars (ESR) on a consolidated basis is considered the largest steel manufacturer in Egypt, with approx. 45% market share in 2009. The initial business dates back to the 70's; however, the company in its present form was incorporated as a joint stock company in 1994, under Law No. 159/1981. In a recent action, management changed the group's name to "Ezz Steel Company (ezzsteel)"; in order to reflect the group's overall products exposure (i.e. rebars as well as flat steel).

The company is majority owned (65%) by Ezz Industries. The latter is a family owned/holding business with a diversified portfolio including steel manufacturing, ceramic and porcelain, and other investments. Ezz Industries is wholly owned by Eng. Ahmed Ezz, the Chairman and Managing Director of ezzsteel (for more details, please refer to Annex 1). It is worth mentioning that management did not furnish **MERIS** with any business and/or financial information covering the holding company, which remains a black box to **MERIS**. The remaining shares are traded in Egypt Stock Exchange and London Stock Exchange. The company is considered one of the active publicly traded companies in the local stock exchange with total market capitalization of EGP 9.2bn as of July 13th, 2010.



Since inception, ezzsteel has expanded rapidly through acquisitions and/or organic growth to be among the largest steel manufacturers in Egypt and the region. This was reflected in the significant increase in designed production capacities (from 400k tons in 1995 to 5.8mn tons in 2009). Ezzsteel will continue to diversify its scope of work by undertaking vertical and horizontal expansion activities in the home-country, the result of which will add another 1.2mn tons to existing capacity to reach 7mn tons of finished products, along with additions of 3.8mn tons of semi-finished products, mainly DRI (for more details, please refer to the Business Considerations Section). The group's steel arm employs 6,000 employees, around 25% of whom are employed through ezzsteel as a stand-alone entity. The company's local staff is complemented by specialized expatriate technicians and operation managers. In order to improve skills, and in turn productivity, the company provides in-house as well as overseas training for the staff.

Corporate Structure

Despite the fact that ezzsteel is not considered a holding company, it acts as a holding and operating company as well. Ezzsteel in its present form owns a controlling stake in three operating subsidiaries, namely: "Al Ezz Dekheila Steel Company (EZDK)", "EZZ Flat Steel (EFS)" and "Ezz Rolling Mills (ERM)".

On a stand-alone basis, ezzsteel produces mainly long/rebars products with a total production capacity of 1.0mn tons per annum and 0.8mn tons of billets. More than 95% of the designed capacity was utilized over the last few years. Although the company produces its own billets, the quantities produced fall short of the company's needs. Ezzsteel's melt shop provides only 60% of the billets requirements; nonetheless, it traded part of these capacities with ERM (a subsidiary) on an arm's length basis. In terms of sales analysis, local sales of rebars, are considered the main driver for sales. Export sales have been diminishing as a result of the slow down in international markets, coupled by the notable increase in the local market demand.

It is worth mentioning that the company depends mainly on scrap as a main feedstock, which is secured externally. The company's site at Sadat City (about 100 km from Cairo) covers an area of 393,000m², of which 49% remains undeveloped. The facility applies state-of-the art technology provided by Danieli (a

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leading Italian manufacturer and supplier of steel technology); encompassing a melt shop and three rolling mills.

The company's investment portfolio stands at almost EGP 6.8bn in March 2010, reflecting a 15% increase on a Y-o-Y basis, backed by the 7.77% increase in ezzsteel stake in ERM to reach 98.5% through the subscription in the capital increase. At the same time, ezzsteel reduced its direct investment¹ in EFS to 33.82% from 75% (for recent changes in corporate profile, refer to annex 1). The cut in stake was acquired by EZDK, through the subscription in the US\$ 330mn capital increase. According to management, the group structure enables the group to reinforce its position as a leading steel producer in the local and regional market, and to optimize the planned horizontal and vertical expansion opportunities. In **MERIS** view, this business model enhances corporate governance fundamentals and adds more value to the group's profile.

Despite the fact that the EGP 1.1bn bond issued in 2008 was executed on a stand-alone basis, for business analysis, **MERIS** factored in the group's performance as well, as we believe that the overall activities are highly correlated. Furthermore, the financial performance of ezzsteel on an unconsolidated basis depends to a high extent on dividends received from subsidiaries.

Currently, ezzsteel corporate structure encompasses the following:

I. Al Ezz Dekheila Steel Company (EZDK)

EZDK, previously known as "Alexandria National Iron & Steel Company S.A.E.", is ezzsteel's foremost subsidiary. The company is considered the largest steel company in Egypt producing both rebars and flat steel. The company was founded in 1982 and has expanded since then, effectively under the same management until ezzsteel acquisition transaction. In 2000, ezzsteel acquired 20% in EZDK, followed by another increase in stake to bring up its ownership to 50.28% in FY06, and finally added another 3% stake reach a 54.59% stake in 2008. The balance is held by different public sector banks and authorities (44.5%) and free floats (1.5%). Currently, ezzsteel management steers the company through the chairman and managing directors. They hold seven seats of a total of 13 board seats and have effectively gained control over EZDK.

In 2Q09, EZDK acquired a majority stake in EFS (55%) through injecting US\$ 330mn in the capital increase. According to management, the rationale of this decision is to compile the group's flat activity under the domain of one controlling entity; taking into consideration that EZDK already operates 1.0mn tons of flat steel. This action is viewed positively by **MERIS**, as it will enhance the business integration in the group.

EZDK is considered the only company in Egypt applying the integrated mini-mill manufacturing technique. Currently, the company operates three direct-reduction iron (DRI) units with a capacity of 1.75mn tons of rebars and 1.0mn ton of flat steel, in addition to 4.75mn tons of DRI and billets (semi-finished products), with more than 95% utilization rate over the last four years. It is worth mentioning that the majority of the DRI and billets products are absorbed internally.

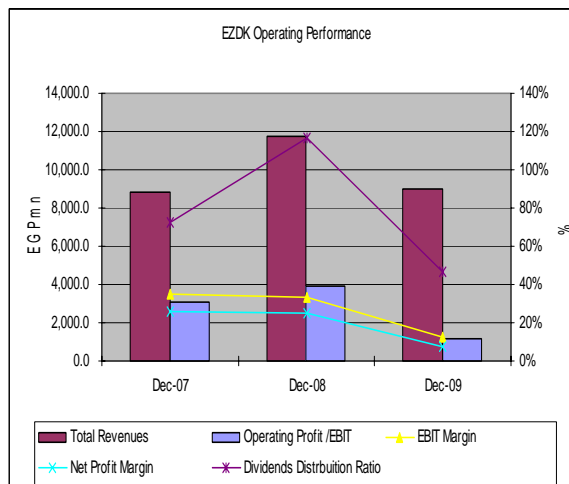
The company production targets primarily the domestic market, with more than 80% of total sales in FY09, compared to 90% in FY08. In general, the company's policy is to satisfy the local demand and to direct the excess capacity to export. Nonetheless, EZDK increased the exposure to the flat steel export market last year, as the company increased its flat production and sales by more than 40% in 2009, in order to cover the absence of EFS.

¹ ESR direct and indirect stake in EFS is 64%

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EZDK revenue continued to be driven by rebar products, which accounts for more than 65% of total sales in FY09, compared to 70% in FY08. This is mainly to capitalize on the increase in local demand, coupled by the severe hit in export markets due to the global financial crisis. Sales figures dropped by more than 20% in FY09, nonetheless, sales volume increased by more than 12%; which is attributed to the decrease in steel ex-factory prices over the same reporting period.

EZDK'S Consildated Financial Performance				
EGPmn	FY09	FY08	FY07	FY06
Turnover	9,027.0	11,768.0	8,825.7	8,102.2
Net Profit	641.7	2,985.8	2,295.6	2,007.5
EBITDA	1,574.2	4,379.2	3,548.5	3,382.9
EBITDA margin (%)	17.4	37.2	40.0	42.0
Div. Distribution (%)	46.0	116.0	72.0	91.0
Total Assets	13,447.9	10,309.3	9,124.7	8,526.0
Total Equity	4,073.5	3,173.9	3,260.3	3,205.4
AROA (%)	5.0	31.0	26.0	22.0
AROE (%)	18.0	93.0	70.0	60.0
T. Debt to EBITDA	3.8	0.9	1.0	1.0
T. Debt to Equity	1.5	1.3	1.2	1.2
EBITDA : interest exp.	3.1	13.3	12.1	11.0



As the graph above illustrates, EZDK financial performance declined in FY09, as EBIT figures decreased by more than 63%, EBITDA margin bottomed down at 17.4%, while EBIT margin hit 13% down from 35% over the last two years. At the bottom line level, the net income margin also fell to 7% from 25% in FY08, which was attributed mainly to the fluctuation in raw material prices, negatively affecting operating margins, coupled with the increase in interest expenses associated with the new debt acquired.

As we mentioned earlier, EZDK acquired majority stake in EFS, as such 2009 is considered the first consolidated statement issued by EZDK. This was attributed to an increase in EZDK debt position by around EGP 2nm, which was reflected negatively in EZDK leverage position. At the same time, EZDK has undertaken a new debt by EGP 400mn during the same period. Nonetheless, it still considered in relatively good shape. However, on the coverage front, the company's performance dropped significantly for the reasons justified earlier.

Going forward, the company's reviewed the dividends distribution pattern in FY09, in light of the notable drop in financial position; as the dividends payout ratio dropped to its lowest level. A practice which is viewed positively; nonetheless, it negatively affects the parent company cash flow position, taking into consideration that EZDK is considered the driving force for the group, backed by the relatively strong profitability margin and the high distribution ratio. According to management, EZDK will maintain the historical dividends distribution trend in the coming years.

II. Ezz Flat Steel (EFS)

EFS was established in 2004 with a designed capacity of 1.2mn tons of flat steel. The technology used in EFS is state-of-the-art provided by Danieli, with a total investment cost of approx. US\$ 740mn. The facility is located in Ain Sukhna – about 40km from Suez. This strategic location gives the facility an important privilege, mianly access to the Red Sea port.

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Since November 2008, and in response to the severe drop in the flat export market, which resulted in a sharp drop in prices and heightened volatility, management decided to make dormant the flat steel production facility until market conditions improve. Nonetheless, management has undertaken initiatives to overcome this challenge through optimizing the use of existing resources; the most important of which is upgrading the technology applied to be able to produce different steel shapes/products (i.e. flat steel as well as rebars products) which will add to the group's existing rebars capacity another 1.2mn tons, if used in producing rebars. This scheme will give management ample room to capitalize on the increase in demand in the local rebars market; while at the same time continue serving the flat steel business when needed. The investment cost is around US\$ 75mn; the upgraded facility commenced the operation in 2Q10.

EFS' Financial Performance				
US\$ mn	3Q09	FY08	FY07	FY06
Turnover	53.5	696.0	520.8	409.0
Net Profit	(68.8)	(53.0)	(19.9)	(9.4)
EBITDA	(70.4)	3.9	51.0	59.9
EBITDA margin (%)	(53.0)	1.0	10.0	15.0
Div. Distribution	0.0	0.0	0.0	0.0
Total Assets	834.6	819.9	844.9	859.1
Total Equity	242.8	201.6	254.4	274.3
AROA (%)	(8.3)	(6.4)	(2.3)	(1.0)
AROE (%)	(30.2)	(20.0)	(7.1)	(3.4)
EBITDA : interest exp.	(1.6)	0.1	1.5	1.5
T. Debt : Equity	1.3	1.3	1.5	1.6
T. Debt : EBITDA	(9.1)	85.3	7.9	7.5

Secondly, management will continue to carry on the vertical integration plan which was initiated earlier, through developing a new DRI plant with a total capacity of 1.75mn ton and a total investment cost of US\$ 400mn. According to management, the investment plan will be financed through a mix of debt and equity and the timeframe for initiating the process is not foreseen before 2012. **MERIS** believes that this expansion scheme will reflect positively on the group's overall performance on a medium to long term horizon; nonetheless, we are rather concerned that this might put extra pressure on the parent company's financial resources in the short term, especially since EFS's financial position - measured by cash flow from operations, leverage and coverage - is not sufficient to finance the expansion needs.

III. Ezz Rolling Mills (ERM):

ERM's Financial Performance				
EGP mn	FY09	FY08	FY07	FY06
Turnover	1,333.1	1,854.0	1,423.8	1,063.4
EBITDA	10.9	11.8	26.4	18.6
EBITDA margin (%)	0.8	0.6	1.9	1.8
Net Profit	13.1	29.0	8.3	(5.4)
Dividends Distribution	0.0	0.0	0.0	0.0
Total Assets	1,403.3	866.3	261.4	295.0
Total Equity	329.4	78.2	49.1	40.8
AROA (%)	1.2	5.1	3.0	(2.0)
AROE (%)	6.4	45.4	18.5	(12.4)
EBITDA : interest exp.	1.7	1.5	2.2	1.2
T. Debt : Equity	0.0	0.8	1.6	2.9
T. Debt : EBITDA	0.0	5.1	3.9	7.2

It was originally established in 1986 under the name "National Baraka for Iron and Steel Company (NBISC)". In 1995, Ezz group decided to acquire NBISC in order to complement and strengthen its activities; ezzsteel currently owns 90.7% of ERM.

The company premises are located in the 10th of Ramadan City covering an area of 60k m². ERM's production facilities were designed and built by Danieli. ERM focuses on the production of coiled rebars and wire mesh to complement the group's product range targeting mainly the Egyptian market.

ERM is currently developing a new DRI facility, through which the company will produce 1.7mn tons of billets to be consumed internally. The

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investment cost of the project is around US\$ 400mn and will be financed through a mix of internal and external resources. The new facility which will commence operation in 2011, will add significantly to the company value and strengthen the group integration.

In a recent action, the company increased the paid in capital from EGP 70mn to EGP 695mn, in order to finance the expansion needs. On the other hand, in January 2010, ERM undertook a syndicated secured loan from several Egyptian banks amounting to EGP 2.27bn to finance the expansion requirement for the DRI plant. The loan is divided into three tranches, the first one was withdrawn in April 2010, amounting to EGP 1.8bn. While, the third tranche, amounting to EGP 120mn, is considered a revolving facility to finance working capital needs for the said project. According to the agreement terms and conditions, the first two tranches should be paid over 18 quarterly installments, starts after the grace period; while the third tranche should be repaid within a maximum of 189 days after the utilization date and the debt entails a variable interest rate of 1% above CBE lending rate. The grace period, for the first two tranches, is for six months starts after the availability period, which is three months after the project completion date or 27 months from signing the loan agreement, whichever is earlier. The loan agreements includes several financial and non-financial covenants, the most important of them includes: 1) debt service coverage ratio with a minimum of 1.15:1 times; 2) gearing ratio as measured by net bank debts as a percentage of shareholders' equity with a maximum of 3:1; 3) leverage ratio as measured by total liabilities as a percentage of net worth not to exceed 3.1:1; 4) the borrower to transfer to the "Revenue Account" formulated with the facility agent, all revenue proceeds starting from the utilization of the revolving facility or upon the expiry of the availability period of the first two tranches, in addition to any proceeds from capital increase; 5) to establish a "Debt Service Amortization Account (DSAA)", an interest bearing account, which should be funded monthly from the revenue account by an amount equivalent to 1/3 of the following repayment and interest due.

It is worth mentioning that the loan is secured by a first degree real estate mortgage for all the tangible and intangible assets of the project, in addition to a corporate guarantee issued by the parent company "ezzsteel". Based on the latter, the parent undertakes to: 1) cover any shortfall of the proposed investment cost (EGP 2.551bn) through their own resources (i.e. capital increase and/or shareholders' subordinated loan); 2) to fund any shortfall in the DSAA; 3) to maintain ezzsteel's shareholding stake (i.e. direct and indirect) in the borrower company with at least 90.7% over the tenor of the debt; 4) ezzsteel should not pledge its shares in the borrower during the tenor of the debt.

Management Strategy

The group is considered among the most prominent and largest steel manufacturers in Egypt and the region. Management has put an emphasis on enhancing the group's profitability margins, without jeopardizing its international standards/quality. In more detail, management expressed its interest in replicating the same successful model of its foremost subsidiary EZDK - with its integrated mini-mill techniques and strong operating margins - across existing and future investments. As such, management is in the process of establishing two new DRI facilities through ERM and EFS, which will be used internally to secure the group's raw material needs. In terms of investment needs, these will be sourced through a mix of internal and external resources. Going forward, the company will continue to evaluate possible regional cross-border investments with high-growth potential where it will have a competitive edge; which was planned to be accomplished through venturing into the Algerian market to capture on the shortage of supply. Initially, the investment scheme proposed to start investment in 2007, to be accomplished by 2011. However, due to the global financial turmoil and management difficulties faced in Algeria, management reviewed the initial plan and decided to start immediately by the DRI facility in ERM and to be followed by the second one in EFS. The time frame is not clear yet regarding the Algeria facility, especially in light of the changes in the foreign investment legislation in Algeria.

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Despite the slowdown in the global steel industry, the Egyptian market has remained resilient, backed by the increase in demand in individual homebuilding which was driven mainly by stimulus programs created by the Egyptian government. This growth in real demand was reflected in an almost full utilization rate witnessed across ezzsteel rebar capacities. Therefore, management is pursuing a strategy to strengthen its leading position in the domestic steel market – especially rebars – capitalizing on the updated technology which will be applied in EFS (refer to the Key Rating Consideration section); while at the same time maintaining its presence in the regional/international markets once the conditions recovered. According to management, ezzsteel will penetrate the domestic market capitalizing on its main competitive advantages, namely: strong brand name “Ezz Steel”; state-of-the-art technology applied which is reflected by consistent high quality accredited by different countries; and a high caliber management team with a long track record in the industry. Moreover, the company enjoys strong and longstanding relationships with local distributors and international trading houses.

The daily business operation is vested with two Managing Directors and the Board of Directors, with Eng. Ahmed Ezz as the Chairman and Managing Director. The latter's involvement in daily operations is moderate, as he is concerned more with investments, strategic and tactical decisions. The BoD consists of seven members, two of whom are executive directors, plus one independent party; while the remaining directors are considered related executives (i.e. engaged as executives in other related party subsidiaries). In terms of corporate governance, **MERIS** believes that the board's composition could be improved significantly. On the other hand, there are three main committees undertaking the decision making process, namely: the pricing, the procurement and the internal audit committees. The pricing and procurement committees are in charge of setting/reviewing all the subsidiaries' pricing policies and the common/strategic purchasing items, in order to enhance the group's bargaining power and maintain the same corporate identity. These committees, which meet on a monthly basis, are headed by Mr. Alaa Aboul Kheir – the Managing Director of EZDK.

Key Rating Considerations

BUSINESS RISK FACTORS

Leading Position in Egypt, with Presence in the Export Markets

As mentioned earlier, the group manufactures different types of steel products (i.e. steel rebars, flat, wire rod ... etc.) with a superior and consistent quality to meet both local and export market requirements. It is worth mentioning that ezzsteel is amongst the few companies producing according to American, British and European standards, which accordingly widens its international trading profile. As a general strategy, ezzsteel will maintain a leading position in its core business in the home market while preserving its presence in other markets. In line with that, the group has expanded aggressively over the last years, with more expansion plans in progress. On the other hand, in light of the global uncertainty, management will hold back export sales pending the improvement in global economic conditions.

Ezzsteel marketing strategy aims at soliciting customers by offering an integrated marketing package that reflects a full understanding of customers' needs in terms of quality, price, payment terms, and delivery. As of December 2009, wholesale distributors account for 90% of local sales (FY08: 87%), while large-ticket contractors increased to 13%. On the other hand, management has increased the number of distributors – from 80 distributors to 200 – to enhance market penetration and to strengthen its distribution channels. As of December 2009, export trading represents approx. 13% of the group's total sales. Ezzsteel, on a stand-alone basis, stopped export market trading, largely due to financial turmoil. Nonetheless, management will maintain the relations with the international trade houses for future exporting activities. Currently, the company has had long and close relationships with six well-known trading houses, including, DAMCO, Sittal, Mitsui, Stemcor and Fernostaal). In **MERIS** view, these trading agreements secure a solid and

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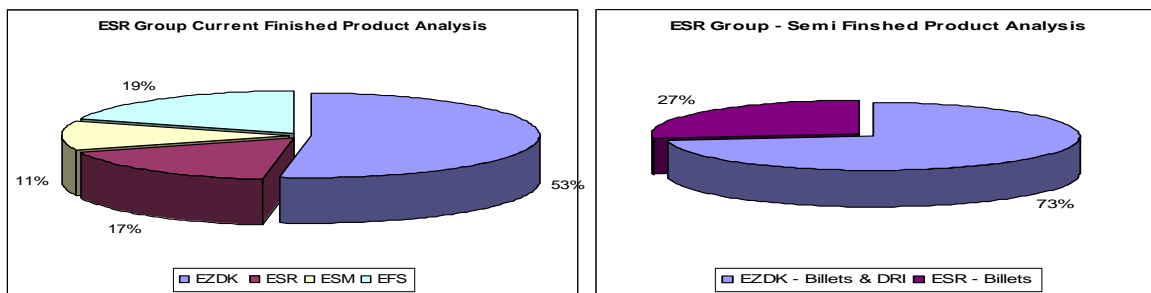
continuous presence in international markets, while at the same time ease the burden on the company's logistics capabilities.

Management centralizes procurement and selling activities in a separate unit to strengthen the group's negotiating abilities. Therefore, all the selling transactions and strategic/raw materials purchasing are conducted through a separate centralized function, in order to enhance the group's bargaining power and maintain the same corporate identity. Nonetheless, the execution stage is accomplished individually on each subsidiary level. On the other hand, in terms of inter-group trading – especially with regard to raw materials (mainly billets) trading – all transactions are accomplished on an arm's length basis and have to be approved by the BoD. In more detail, the company has to execute all the raw materials trading through a public tender. According to management, these practices will be maintained in the future.

On the other hand, ezzsteel is considered highly vulnerable to foreign currency risk, as around 90% of the raw material needs are imported, while the main foreign currency resources is export sales, which is considered insufficient to cover the company's foreign currency obligations. Management maintains a centralized hedging policy on the group level, which controls this risk to a certain extent. Going forward, this challenge is anticipated to ease relatively over the medium to long term, following the operation of the DRI plant that will secure most of the group's raw material needs.

Management Has Undertaken a Number of Corporate Initiatives, which are Anticipated to Reflect Positively on the Overall Performance

The group's combined designed production capacity stands at 5.8mn tons, classified into long steel and flat steel, 60% and 40% respectively; in addition to 5.5mn tons of semi finished products in the form of billets and DRI, all are consumed internally. In FY09, the group's actual production stood at 4.26mn tons reflecting 6.5% decrease on a Y-o-Y basis (FY08: 4.6mn tons). The decline in production reflected a 30% decrease in flat steel capacities, driven mainly by the dormant EFS. Nonetheless, the remaining production facilities within the group are operating at almost full capacity over the last year.



Ezzsteel on a stand-alone basis accounts for around 20% of finished products, mainly long steel, in addition to the semi finished products which are used for internal production, and/or shared with ERM.

As we mentioned earlier, in November 2008, management decided to temporarily holdback production activities in EFS facility – directed mainly to export markets – until global market conditions improve. With equal note, management has refined the expansion scheme which was initiated earlier, to take into consideration the current global macro economic conditions. The most important aspect of the revised scheme is to continue the vertical and horizontal expansions aiming to replicate EZDK successful model, while focusing on capturing the increase in demand in the local market. **MERIS** believes that the revised scheme is anticipated to further strengthen the group's position and to intensify synergies, which will reflect positively on the group's overall business and financial performance on the medium to long term basis.

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The plan will be undertaken through different dimensions:

..... **Optimizing Resources through Upgrading EFS Melt Shop**

In light of the slow down in export markets, mainly flat trading, management took initiatives to upgrade technology applied in EFS facility – 1.2mn tons per annum – to tolerate the existing melt shop to produce flat as well as rebars products. The new technology started operation in early 2Q10 and carries an investment cost of around US\$ 75mn. MERIS views this initiative positively as it will give the group an edge to be flexible to capture the increase in demand in the local rebars market, and at the same time maintain its presence in the flat market when needed.

..... **Construction of Two New DRI Plant**

Ezzsteel intends to establish two new DRI plants: the first facility has already started the construction phase through ERM and is anticipated to commence operation in 2011, to be followed by the second facility in EFS. The timeframe for commencing the operation of the latter facility is not clear yet. Each production facility will cost around US\$ 400mn, to be financed through a mix of internal and external resources. The combined outcome is approx 3.2mn tons per annum, which will secure the shortage in the group's needs of raw materials. According to management, the outcome of the new facility will be traded with other inter-group subsidiaries on an arm's length basis.

It is worth mentioning that ezzsteel's major raw material is scrap; the majority of needs are subject to spot trading. Furthermore, raw materials represent a significant proportion of the cost production (on average 90%). The company established a long term relation with major international suppliers, and maintains a good stocking policy (to stock one month of the imported raw material needs). According to management they have never faced shortages in raw material requirements; however, this exposes the company to the vulnerability of the availability of raw materials and to foreign currency risk. Therefore, this vertical integration will secure its required DRI and reduce its exposure to the cyclicity of raw material prices and availability. MERIS believes that this initiative will be a turning point in the group's performance.

..... **Greenfield Project in Algeria**

Ezzsteel group is planning to execute the first regional facility in Algeria which will comprise a DRI plant, melt shop and a rolling mill. The wholly owned subsidiary initially was projected to manufacture 1.5mn tons per annum in the first phase by year 2011, to be further increased to 3mn tons per annum. The investment cost of the first phase is around US\$ 750mn, to be financed through a mix of internal and external resources. Despite the fact that management has signed the Memorandum of Understanding with the Algerian Government in October 2007, this plan has been delayed several times as a result of changes in the Algerian foreign investment regulatory framework. Going forward, regardless of the several delays in initiating the project, management is still considering the above mentioned investment; however, the timeframe is not clear yet and is subject to assessing the feasibility of the new decree.

..... **Ezzsteel Cash Generating Ability Is Highly Vulnerable, as it Depends Mainly on Dividends Received from Subsidiaries**

Despite the fact that MERIS views the above detailed scheme positively, we remain rather concerned about ezzsteel's stand-alone cash generating ability; taking into account that the company will be committed to support subsidiaries in their expansion phase. This was recently apparent through the increase in inter-group balances and several capital increases on the subsidiaries front.

With equal note, the subsidiaries' – except EZDK – financial position is stressed. As it will be highlighted in the Financial Section, the company's stand-alone cash flow depends highly on EZDK proceeds distribution. Consequently, it is likely to be negatively affected in case of any fluctuation/unforeseen events associated with this income stream, especially in the absence of cash received from other subsidiaries. In FY09, EZDK dividends payout ratio was decreased to less than 50% compared to 116% in

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FY08, negatively affected ezzsteel's cash flow position. Going forward, management believes that ERM will start distributing dividends over the coming three years, upon the completion of the on-going expansion plan.

A Visionary Owner/Fonder and a Strong Management Team Supports the Business

Eng. Ahmed Ezz, the largest single shareholder is a prominent businessman in Egypt, with very significant presence in the political community – heading the Logistics Committee in the National Democratic Party, and a parliament member heading the Planning and Budget Committee in the People's Assembly. The chairman's political situation is considered very controversial. On the one hand, it gives him access to government decision makers, to share business obstacles and challenges with them, and attain their support. On the other hand, this has drawn overwhelming criticism and attacks from the community at large (i.e. media, public, and intellectuals), particularly where it comes to the aspect of what many consider as a questionable mix between business and political involvement. At best this is likely to raise the risk profile of the group. According to management, they do not see this criticism as a real threat to the group's performance because in their view the group is strictly in compliance with local competitive practices and international standards. This practice was confirmed by “the Competition Authority” which investigated the anti-competitive practices by steel manufacturers and proved that local steel manufacturers and ezzsteel in specific is in compliance with best practices. Nonetheless, management doesn't seem to have succeeded in conveying this situation clearly to the media/public, in order to soften this aggressive sentiment towards the group.

As for the overall management of the company, MERIS believes that the company is well managed by an experienced and capable management team with a good track record and knowledge of the local industry. Technical and logistics management and human resource development are also considered key success factors.

***The Steel Industry is Highly Correlated to Overall Macroeconomic Conditions
..... Recent Changes in the Operating Environment Might Pressure Business
Dynamics***

The Egyptian steel industry dates back to the 1940's, mainly under public sector companies' control. In 1995, the local steel industry faced a major turning point, as private investors joined the industry injecting around EGP 12bn in investments. Currently, the local steel industry contains 21 players, only 2 of which are government-owned companies. The total designed capacity amounts to 8.5mn² ton per annum (more than 70% of which was utilized in 2009). On the other hand, the Egyptian steel market is considered an oligopoly market, with the biggest two players (i.e. Ezz group and Beshay Steel) accounting for around 70% of the designed production capacity, and an approximately 50% market share.

The Egyptian steel industry is considered the biggest steel producer in the Middle East, manufacturing around 6.2mn tons in 2009 (of which ezzsteel group accounts for more than 70% of the produced capacities). Rebars accounts for 70% of the local capacities, while the flat steel accounts for the remaining balance. On the other hand, local consumption, of rebars, stands around 7.3mn³ tons in 2009 reflecting more than 20% increase on a Y-o-Y basis and 17% increase in flat steel products to reach 1.12mn tons in 2009. The increase in consumption was backed by the boom in the housing sector, infrastructure and construction projects; coupled by the drop in local steel prices over last two years, which was a driver to stimulate demand.

Historically, in terms of steel trading balance, Egypt used to be a net importer country; however, starting from year 2000, it shifted to be more export oriented, capitalizing on the excess in supply and the more disciplined and efficient approaches which private steel manufacturers applied. Going forward, starting from 4Q08, this trend started to reverse. The market witnessed a substantial amount of imported steel

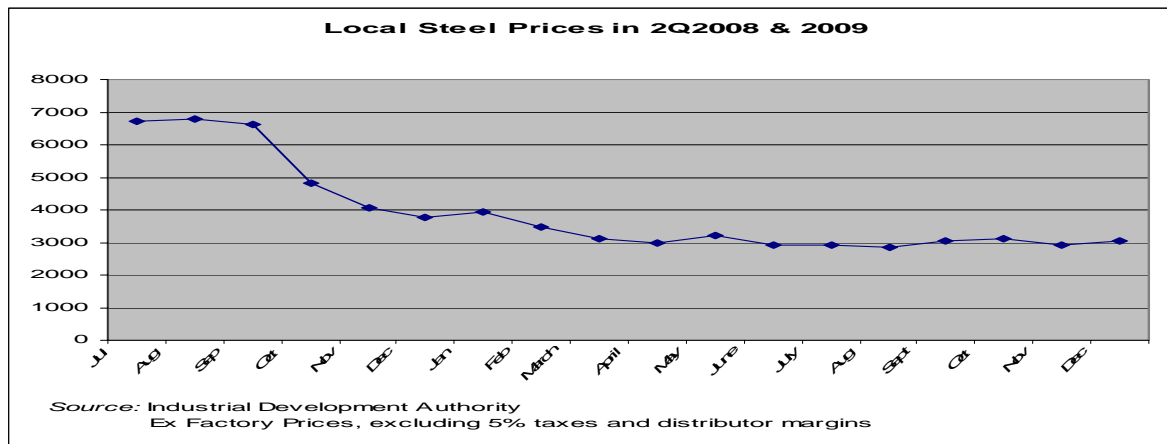
² Source: Central Agency for Public Mobilization And Statistics

³ESR, Management Results

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products influx, which was largely attributed to the increase in demand associated mainly with the decrease in the commodity selling price, which in turn stimulated the increase in construction activities.

Currently, the local steel consumption stands at 7.2mn tons, and is expected to reach 7.6mn tons by the end of 2010; 85% supplied locally. The increase in imported steel products over the last two years, notably affected the local market structure. Imported products increased its market share to capture more than 30% of rebars market and 45% of flat steel (compared to around 10% for each). Therefore, ezzsteel market share dropped in FY09 to bottom down at 44% in rebars and 41% in flat steel, compared to 63% and 41% respectively. Going forward, upon the operation of EFS's new facility, and in case directing the available 1.2mn ton existing capacities to rebars local market, the group will be in a better position to increase its market share.



Local steel prices follow the international commodity prices, as such, local prices have shown an upward trend peaking in August 2008, reflecting the skyrocketing of raw material prices (i.e. scrap and iron ore). Since then, prices have decreased notably reflecting the slow down in the global economic conditions which affected raw materials as well as steel selling prices. Going forward, starting from 2010, steel prices reversed again, in light of the recovery in the raw material prices. On the raw material front, major iron ore producers agreed in April 2010, to adjust raw material process on a quarterly basis, instead of annually. The price will be calculated using a three month average of iron ore prices indices. This would lead to greater volatility of input costs for steel producer and accordingly pressure margins, especially if the producer were not able to pass this cost fluctuation to end-users.

With equal note, in May 2010, the Egyptian government imposed a 3% sales tax rate on steel producers, to be applied starting from July 2010. Management doesn't foresee any implication on the projected profitability margin, as the new taxes will be passed to the end consumer. Nonetheless, **MERIS** is rather concerned about the implication of the above-mentioned taxes on the overall steel sector performance, especially since it was coupled with an additional 5% sales tax imposed on the cement industry, which might negatively affect the construction sector overall.

FINANCIAL RISK FACTORS

Accounting Quality

Hazem Hassan, a member of the KPMG firm, is the auditor of ERS Group and all of its subsidiaries. The company's financial statements have been prepared in accordance with Egyptian Accounting Standards (EAS). However, in the auditor's opinion, there are no material differences between EAS and the International Accounting Standards (IAS). For the rated bond transaction, **MERIS** financial analysis is based on the audited unconsolidated accounts on a stand-alone basis; while for the entity rating, we have factored in the overall business profile. Historically, there was no recourse for any of the subsidiaries'

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existing debt to the parent company. However, in January 2010, the parent company guaranteed a syndicated loan granted to ERM. **MERIS**, is concerned about the change in the recourse policy, as it would expose the company to an off balance sheet risk in time of distressed cash flow at both the holding and subsidiary level.

Revenue Decreased Driven by Drop in Average Selling Prices
Figure 1: Earnings & Profitability

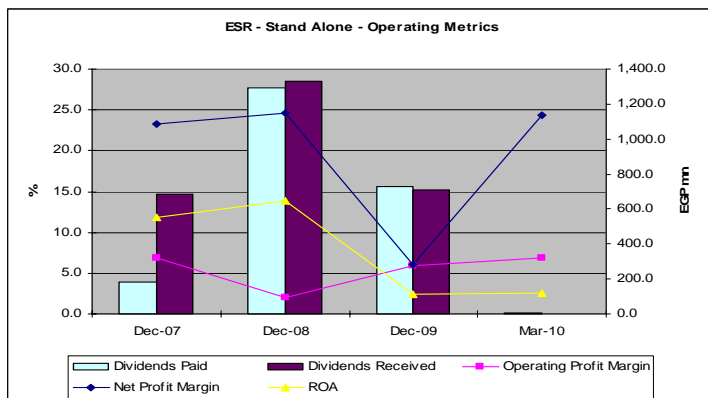
	FY09	FY08	FY07	FY06
Total Revenue	4,112.7	5,950.2	4,092.5	3,414.4
Growth (%)	(31.0)	45.4	19.9	11.4
EBITDA	245.4	122.3	281.1	286.8
EBITDA Margin (%)	6.0	2.1	6.9	8.4
Operating Profit	175.9	54.1	216.9	220.9
Operating Profit Margin (%)	4.3	0.9	5.3	6.5
EBIT to Tangible Assets	5.5	1.6	6.6	6.9
Interest Expense	(218.5)	(220.5)	(205.4)	(212.9)
Interest Income	36.5	30.5	3.1	0.5
Net Income Pre Dividends				
Received from Subsidiaries	(462)	130.2	265.6	29.7
Net Income	249.6	1,462.7	952.8	789.1
Net Income Margin (%)	6.1	24.6	23.3	23.1
Return on Avg Assets (%)	2.5	13.9	11.8	10.9
Cash & C. Equivalent/ C. Liabilities (%)	15.0	109.5	14.4	26.0

Despite the fluctuation in ezzsteel financial performance over the last two years, the company's performance demonstrated resilience compared to the global peer group, especially in FY09. This was attributed to the moderate GDP growth in the local market, coupled with the real demand drivers supported by the government stimulus packages; accordingly the company operated at nearly full capacity on a rebars basis over the last years.

In FY09, revenue figures dropped significantly, attributed to the decrease in steel selling prices by more than 20% on a y-o-y basis (ex-factory prices), nonetheless, sales volumes were maintained within the same range. Operating margins improved compared to the previous year's results,

to stand at 6% as an EBIT margin. This was due to changes in the cost structure, as 2008's cost structure was inflated by the cost increase associated with the lag between the raw materials cost and the finished goods selling prices. The cost difference reflected in a decrease in cost of sale as a percentage of sales from 97.5% in FY08 to 92% on FY09. In other words, management decided to drive the high cost inventory out of the system entirely in financial year 2008, which hit the stand alone performance significantly. Going forward, this upward trend was reversed on the bottom line, as a result of the significant drop in dividends received from subsidiaries, mainly EZDK, which is considered the focal engine for ezzsteel's profitability position.

The drop in the bottom line justifies the severe drop in the return on assets ratio; nonetheless the company's performance is still aligned with the rating range/results.



In a recent action, ezzsteel announced 1Q10 results, which reported revenue and net income figures at EGP 1.14bn and 277.7mn, showing a drop of 22% and 11% respectively. The operating profit margins were also affected by the stressed/competitive operating environment, to bottom down at 5% compared to 7% on a Y-o-Y basis. The driver for this drop was the increase in

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COGS to revenue ratio to 93% compared to an average of 91% on a quarter basis.

Despite the fact that management positively views the outlook for the local steel industry with a continued strong demand in the short to medium horizon, **MERIS** believes that the company's financial performance will be under some pressure reflected by the projection of a slow down in macro-economic conditions, and the influx of the imported products. However, the expansion scheme which management initiated—including the updated/flexibility technology and the new DRI plants which we mentioned earlier are projected to soften the pressure on the group's cost structure and profitability margins.

It is worth mentioning that the domestic operations are now considered the sole contribution to total unconsolidated sales in FY09, compared to 90% in FY07. Furthermore, long steel products comprised the majority of local sales figures (EGP 2,959.6mn, out of EGP 4,112.7mn). In light of the global recession, ezzsteel cut export sales in order to cater for the increase in local demand, according to management. Distributor sales account for 65% of ezzsteel's total sales in FY09, while the large contractors account for 7% (up from 3% in FY07).

Cash Generating Ability is still under Substantial Pressure

Figure 2: Cash Flow & Coverages

Figures in EGP mn	FY09	FY08	FY07	FY06
Funds Flow From Operation (FFO)	71.4	(16.2)	102.9	108.8
Retained Cash Flow (RCF)	(658.0)	(1,310.8)	(79.4)	108.8
Changes in Working Capital	(805.2)	(961.9)	(285.9)	(124.1)
Dividends Paid	(729.4)	(1,294.6)	(182.3)	0.0
Dividends Received	711.6	1,332.5	687.2	758.4
Capex	(22.8)	(55.6)	(132.9)	(16.1)
Free Cash Flow (FCF)	(744.4)	(995.8)	189.0	727.0
Free Cash Flow (excluding Dividends Received)	(1,485.9)	(2,328.3)	(498.2)	(31.4)
RCF/Capex (%)	(28.9)	(23.6)	(0.6)	6.8
EBIT / Interest Expenses (X)	0.8	0.2	1.1	1.0
Dividend Payout Ratio (%)	50.0	136.0	23.0	0.0

As the table illustrates, ezzsteel's cash generating ability represented in free cash flow (FCF) figures and retained cash flow (RCF) have been hampered significantly over the last two years. This was mainly due to excessive dividends distribution.

On the RCF front, the continuous negative change in working capital is considered a negative driver, mainly attributed to the increase in inter-group transactions and changes in related-party transactions

amounted to EGP 1.6bn in FY09, associated mainly with 1) ezzsteel joint activities with ERM; mainly represented in trading activities and settlement/clearances of cheques under collection. For trading activities, ezzsteel deals with subsidiaries on an arm's length basis. The company functions as a centralized trading hub for ERM selling transactions. According to management, ezzsteel has not experienced any receivable collection problems though, because the majority of the selling transactions are on a cash basis. Going forward, in 1Q10 most of the outstanding balances were settled, reflecting positively on ezzsteel cash flow position, as RCF and FCF reported EGP 26.1mn and 877.2mn respectively. 2) Outstanding balances with EFS, amounting to more than EGP 1.0bn. According to management, this balance is not expected to be settled in the short to medium term; as EFS projected/operating cash flow will be directed entirely to financing the on-going expansion scheme (i.e. flexibility facility and DRI plan) and the associated financing needs. **MERIS** believes that management needs to closely monitor the working capital management in the future.

It is worth mentioning that the majority of the consolidated capex requirements are executed on the subsidiaries level. The group's capex scheme focuses on the vertical integration and capacity expansion; with two new DRI plants, in addition to the advanced technology to be applied to the existing billet cluster in EFS. The plan will cost around US\$ 1.0bn, and will be executed over medium to long term horizon and to be financed through a mixture of internal and external resources, 20% of which was expensed as of 1Q10

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and the remaining amount will be expensed over a minimum of the coming five years. **MERIS** continues to view the expansion initiatives as solid steps toward reinforcing the group's overall performance. Nevertheless, we are somewhat concerned about the company's cash generating ability in the short term; especially in light of the relatively weak financial fundamentals of ERM and EFS and the decline in dividends received from EZDK, which is the key engine for ezzsteel's cash generating ability.

The company's coverage position as measured by EBIT to interest expense ratio is considered weak, as it hardly covers the interest needs, mainly due to the decrease in EBIT figures.

Currently, ezzsteel receives dividends only from its key engine EZDK, which is considered one of the supporting factors for ezzsteel's cash position. Historically, EZDK used to distribute between 50% and 100% of the net profits; a practice which is projected to continue in the future. Moreover, following the completion of the expansion plan, management anticipates ERM to start distributing dividends over the medium term. On the other hand, ezzsteel aggressively distributed dividends over the last two years, capitalizing on accumulated retained earnings and available cash balances. According to management, this practice will not be continued in the near future, as the company will be back to its old, more conservative track in dividend distribution activities in 2010.

Debt Structure:

Figure 3: Financial Leverage

Figures in EGP mn	FY09	FY08	FY07	FY06
Short-term Debt	1,026.3	710.2	851.6	640.7
Long-term Debt	880.0	1,100.0	438.8	582.2
Total Bank Debt	1,906.3	1,810.2	1,290.4	1,222.9
Less: Cash and Cash Equivalent	201.2	1,127.0	191.9	240.4
Net Financial Debt	1,705.1	683.2	1,098.5	982.5
<i>Debt Adjustments:</i>				
Capital commitments & contingent L.	13.4	8.6	89.7	59.7
Subsidiary's Debt with Recourse to the Parent	0.0	0.0	0.0	0.0
Adjusted Debts	1,919.6	1,818.8	1,380.1	1,282.6
O. Financial Obligations (Deferred Taxes)	69.3	62.0	53.3	35.3
Equity	7,850.3	8,335.7	6,222.8	5,675.2
Debt/ EBITDA (x) (Average 3 years)	7.7	6.3	5.0	5.3
Debt / Equity (%)	24.0	22.0	21.0	22.0
FCF (including Div. Received) /Debt (%)	(40.6)	(55.0)	14.6	59.4
Adjusted Debt to Capitalization (%)	19.7	17.9	18.3	18.6
RCF / Net Financial Debt (%)	(86.0)	(333.0)	(33.0)	(2.0)
CFO-Dividends / Debt	(34.5)	(72.4)	(6.2)	8.9

In terms of debt structure, around 50% of the company's debt position is short term in nature containing bank credit facilities, overdraft and the current portion of long term obligations. The company also had access to committed credit facilities secured from ten banks, equivalent to EGP 1,840mn; secured in both local and foreign currencies, of which 83% were utilized as of June 2010.

Ezzsteel sole outstanding long-term debt is equivalent to EGP 1,100mn associated with the seven year bond, denominated

in local currency. The unsecured bond which was issued in mid 2008 has a two-year grace period and bears a floating (11.75%) semi annual coupon rate. In 2Q10, the company paid the first amortization installment, amounting to EGP 110mn.

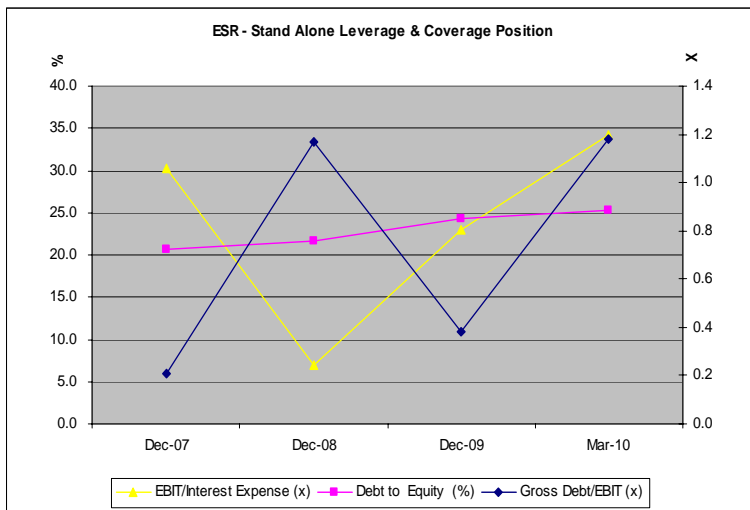
The bond terms and conditions contain different covenants, the most important of which are:

- The Long Term Debt Service Coverage Ratio (as measured by EBITDA + Investment Revenue/CPLTD + net interest position) is not less than 1.5: 1.0 throughout the life of the bond;
- The Long Term Debt to Equity Ratio is not more than 1.0:1.0 throughout the entire life of the issue; Coverage ratio as measured by EBITDA + investment revenue over net interest position to net interest – is not less than 2.0 :1.0 over the tenure of the bond.
- Bondholders should rank pari passu with any potential lenders;
- Ezzsteel's main shareholder, Eng. Ahmed Ezz, is committed to maintaining a minimum of a 51% shareholder stake, either directly or indirectly, in all the current subsidiaries (namely: EZDK, ERM and EFS) over the life of the bond;

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- The company undertakes to submit an annual audited certificate along with its annual audited financials, confirming that the accumulated investment income plus any increase in paid-in capital during the period starting from the issuance of the bond until the end of the relevant fiscal years shall exceed or be equivalent to the installments payable according to the bond amortization schedule during same said period, after the financing of any new investments.

Currently, as per **MERIS** analysis and the auditor certification, the company is considered in compliance with the above-mentioned conditions.

Credit Metrics are also Fluctuated Over Last Two Years.....


Ezzsteel credit metrics measured by average three years debt to EBITDA ratio decreased over the last two reporting periods, as a result of the slow down in the company's overall performance. Furthermore, the FCF, including dividends received from subsidiaries, as a percentage of gross debt dropped significantly over the last two years, mainly due to the excessive dividends distribution policy which management applied recently, which is considered a concern for **MERIS**, especially since it is coupled with a slow down in dividends received from subsidiaries.

ezzsteel company**Rating Outlook**

Although, the company's operating performance was vulnerable to the pressure of the global steel industry, ezzsteel was able to rank in a better position compared to peer group, which justifies the stable outlook.

What Could Change the Rating - UP

Ezzsteel rating may undergo an upgrade in case of the completion of the expansion scheme, thus reflecting positively on financial and operating performance.

What Could Change the Rating - DOWN

There are a number of factors which might trigger a rating downgrade, the most important of which are: 1) the pressure that the parent company might face to support the expansion activities undertaken by the subsidiaries, coupled with any changes in the existing group's structure, which might affect the level of dividends received from subsidiaries (mainly from EZDK); 2) the continued volatility of input costs without the ability to pass the increased costs on to the end-user; 3) deterioration in the overall economic environment, and the steel industry, could adversely affect the company's business operation and consequently put more pressure on financial performance; 4) Ezzsteel's inability to maintain a leading market position, especially in light of the tougher competition and the influx of imported products.

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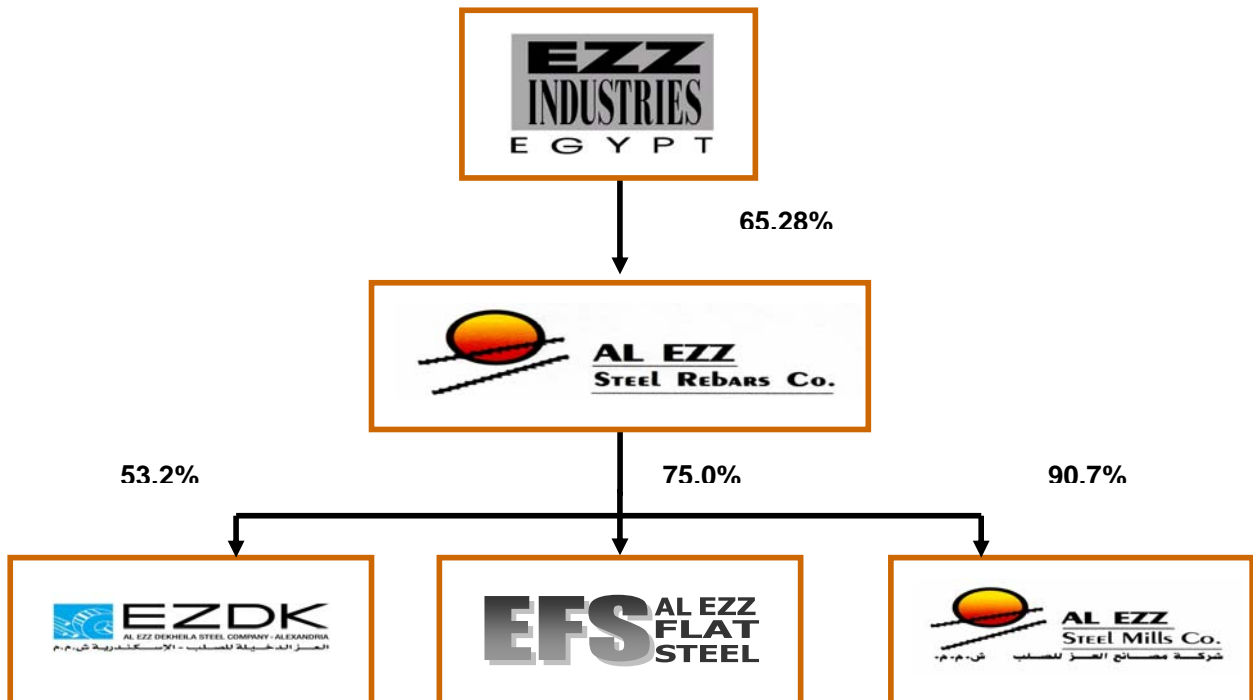
Annex 1: Corporate Structure / Investment Portfolio

Revised Corporate Structure:



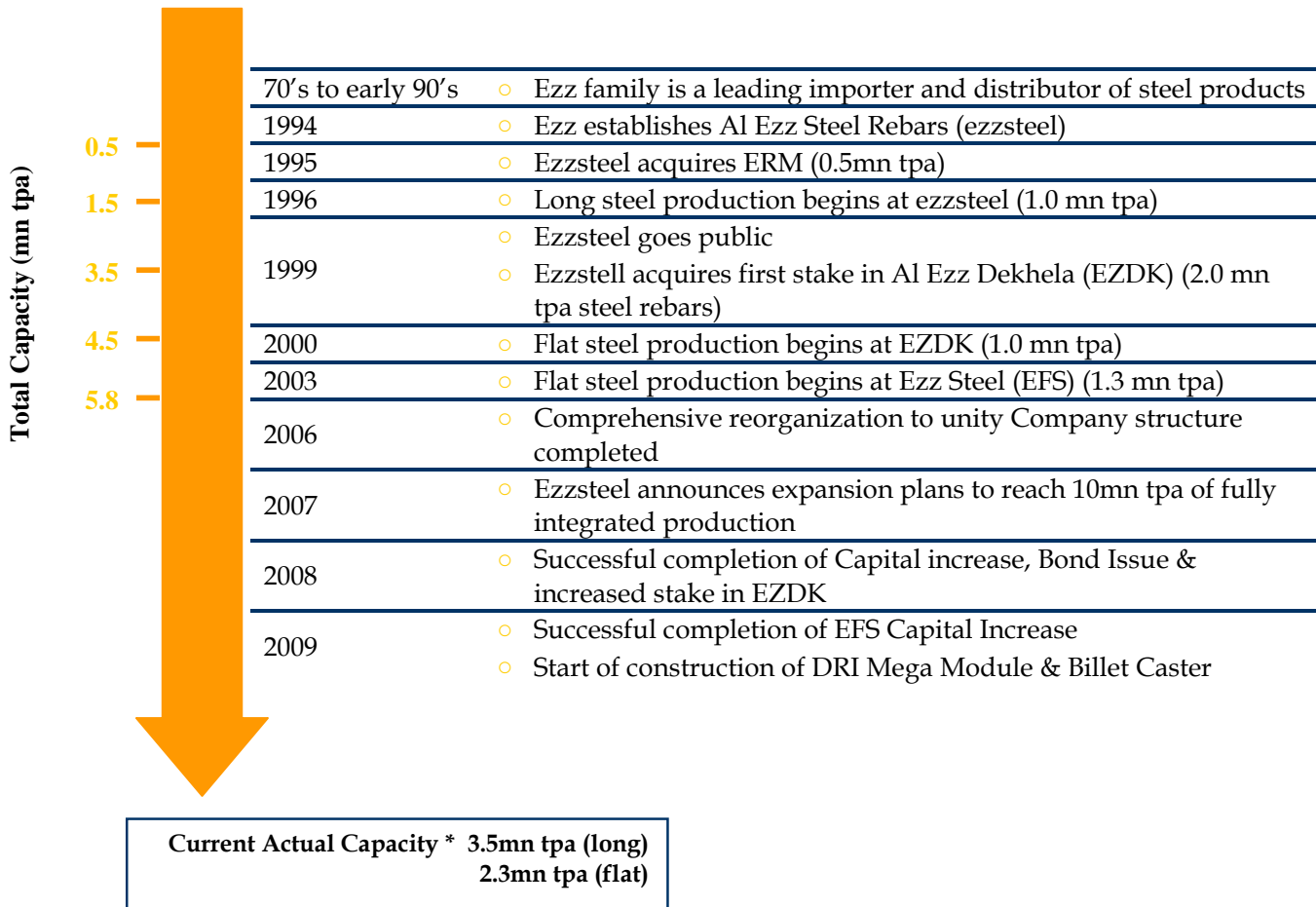
Note: ezzsteel direct and indirect stake in EFS: 64%

Previous Shareholding Structure:



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Annex 2: Growth Phases



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Annex 3: National Rating Scale

Quality of credit	Long	Short					
	Gilt edged	AAA		Prime 1	Investment Grade		
Very high	AA+						
	AA						
	AA-						
Upper-medium	A+	Prime 2	Investment Grade				
	A						
	A-						
Medium grade	BBB+	Prime 3				Investment Grade	
	BBB						
	BBB-						
Questionable	BB+	Not Prime		Speculative Grade			
	BB						
	BB-						
Poor quality	B+		Not Prime		Speculative Grade		
	B						
	B-						
Very poor	CCC+					Not Prime	Speculative Grade
	CCC						
	CCC-						
	CC						
	C						

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