

## Industrial

December 23, 2011

Industry Comment

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## Infrastructure &amp; Construction | Steel Processors &amp; Building Components

## Steel Periodical IX: Steady as She Goes

## Event

We offer a year-end update on the North American steel sector and the key trends that influence the stocks within our Infrastructure and Construction (I&C) coverage universe that are levered to the industry.

## Action

Our 'top pick' in the sector remains Russel Metals mainly because: (i) we expect the growth of unconventional oil and gas resources and the advancements in hydraulic fracturing techniques to power the Energy Tubular Products division's earnings in 4Q11 and 1Q12; (ii) the Metals Service Centers and Steel Distributors units have successfully adjusted to the post-2008 reality of lower steel industry shipments and weaker demand for small construction projects, and today can churn out steady, adequate returns, and (iii) the firm boasts industry-leading inventory turns and ROEs (despite its low debt leverage). We are also constructive on ADF Group because the small-cap firm has remained profitable through the bottom of the U.S. commercial construction cycle and its shares look deeply undervalued to us. We believe Canam Group is similarly undervalued on a P/B basis, but the company carries too much debt to our liking and the outlook for commercial construction in the U.S. remains subdued at best. Accordingly, we maintain our neutral stance on Canam.

## Analysis

Our research and channel checks suggest a disconnect between the dampened enthusiasm for the North American steel sector at present and its underlying fundamentals. In the past weeks, many North American steel producers have issued press releases cautioning that their 4Q11 results would fall short of analyst expectations. This decline reflects lower steel prices and metal margins for sheet products, which are the direct result of some new domestic supply coming to market. In addition to the increased competition, the market volatility early in the fourth quarter contributed to buyer uncertainty and negatively impacted buying patterns. We believe this drop in sheet metal prices has caused some undue pressure on the stock prices of the steel distributors (which have actually continued marching to a different beat than the producers) and provided investors with an excellent opportunity to buy quality names like Russel Metals at a discount.

## Valuation

Our \$29.00 target price on Russel Metals is predicated on an EV/EBITDA multiple of 7.6x our 2012 estimates, which represents the North American service center operators' ten-year average. Our \$5.50 target for Canam Group is derived using a multiple of 0.7x our estimated book value at Dec-30-11. Our target multiple represents the low end of the stocks 10-year P/B multiple range, which we feel is warranted given the absence of catalyst we see for the firm in the short to medium term. We value ADF Group similarly to Canam, at 0.7x estimated book value, notwithstanding its smaller capitalization and more concentrated customer base, because the steel fabricator has a stronger financial position and healthier operating performance of late.

Company	Ticker Primary	Ticker Secondary	Current Price	Target Price (6-12 months)	Dividend Yield	Total Return To Target	Rating
<b>Steel Processors &amp; Building Components</b>							
ADF Group Inc.	DRX-TSX		C\$1.28	C\$2.00	2%	58%	Outperform 2
Canam Group	CAM-TSX		C\$3.81	C\$5.50	0%	44%	Market Perform 3
Russel Metals	RUS-TSX		C\$22.24	C\$29.00	5%	36%	Outperform 2

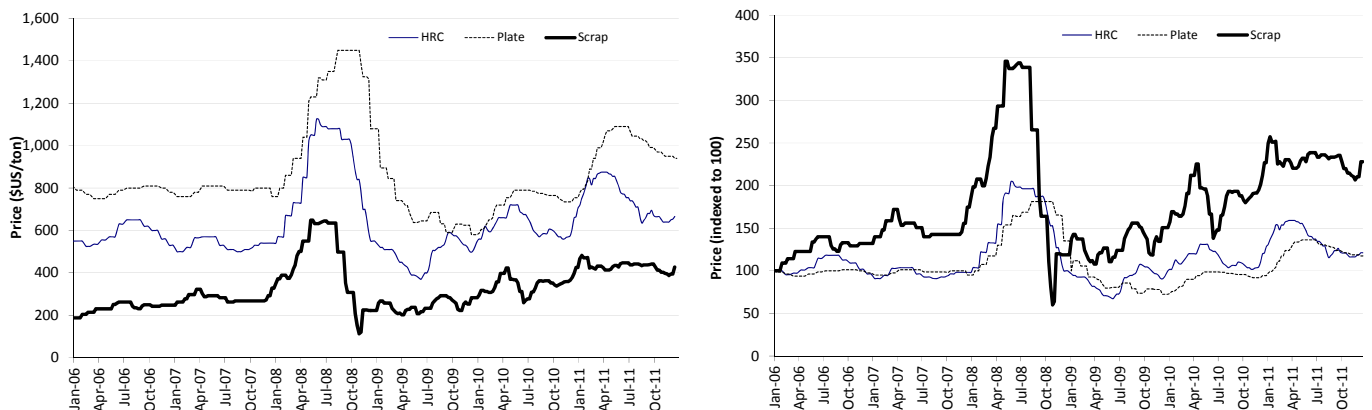
Raymond James Ltd.

### Investment Perspective

Our research and channel checks suggest a disconnect between the dampened enthusiasm for the steel sector at present and its underlying fundamentals.

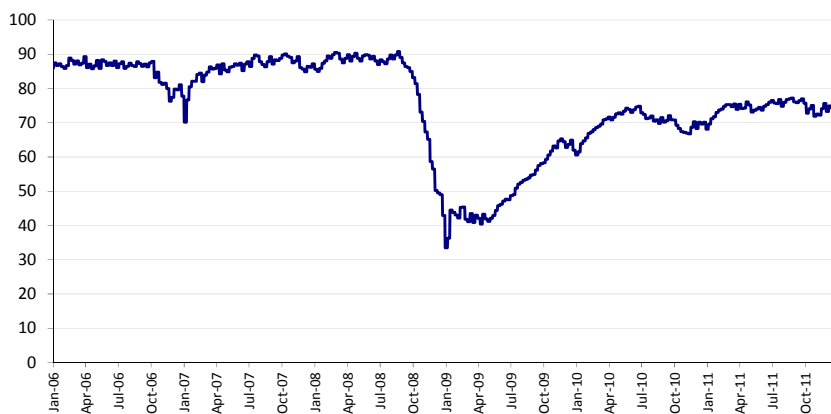
- ◆ **Producers at the Mercy of Scrap Steel.** The price differential between scrap and steel has narrowed materially of late, pressuring the margins of North American mills. Some, over the past weeks, even felt compelled to caution the Street that their 4Q11 results would come in short of analyst expectations. On the supply side, prices for scrap have run relatively strong for most of 2011 on the back of reasonable levels of growth from China and difficulties in sourcing the material domestically (see Exhibit 1). But on the demand side, mills have found it difficult to implement price increases amid a generally lackluster economy, new capacity additions (see Exhibit 2) and the uncertainty that continues to linger in the financial markets. However, we are starting to see signs of improved demand from the heavy equipment, auto and manufacturing industries heading into 2012, which bodes well for the producers.

**Exhibit 1: North American HRC, Plate and Scrap Prices: LHS (US\$/ton); RHS (indexed to 100)**



Source: Bloomberg, Raymond James Ltd.

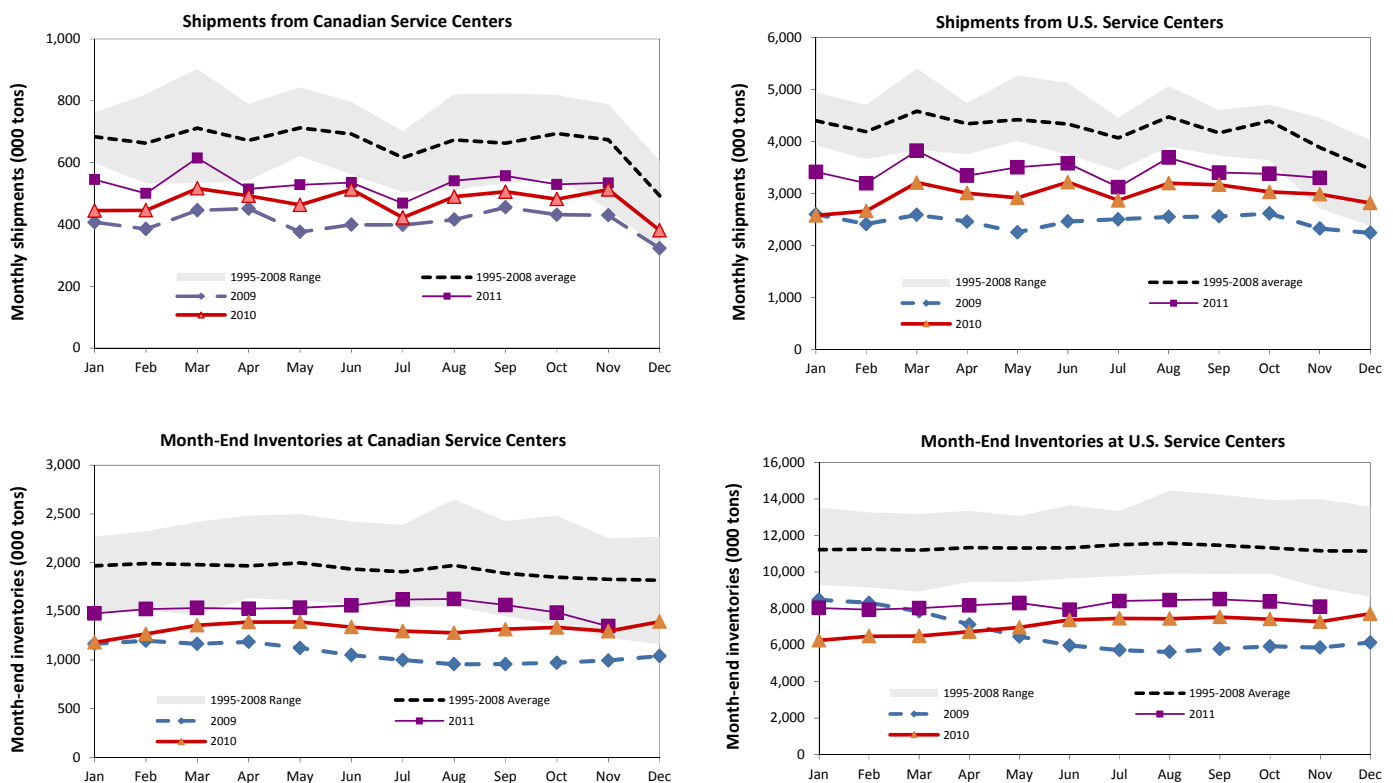
**Exhibit 2: North American Raw Steel Capacity Utilization**



Source: American Iron and Steel Institute; Raymond James Ltd.

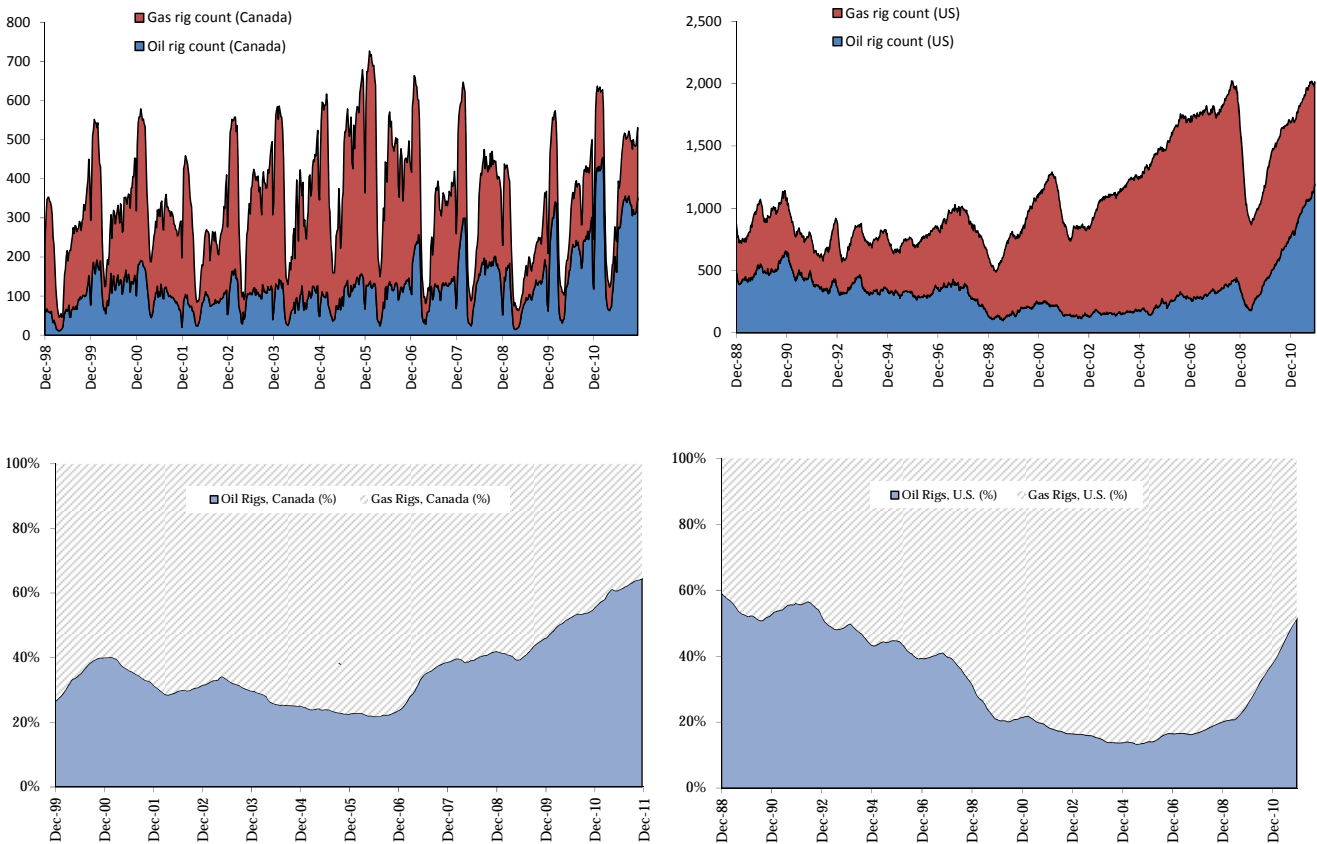
- Service Centre Shipment Growth Moderates.** Earlier this week, the Metals Service Center Institute (MSCI) released its activity report for November 2011. U.S. and Canadian shipments were up 11% and 4% year-over-year, respectively, and largely in-line with our current expectations for Russel’s metals service center business. Sequentially, shipments were down 2% in the U.S., and up 4% in Canada. Overall, shipments are much improved over 2009 and 2010 levels, but remain at the low end of historical norms (see Exhibit 3). Inventories remain tight, suggesting that buyers continue to exhibit extreme caution with their purchases. The industry is now turning over inventories at a much faster clip than it did five years ago, which is helping lower the risk of large inventory losses for its participants. It also had the unintended consequence of amplifying both the volatility and frequency of steel cycles—a net positive for service centers, in our view, but not necessarily for the less flexible integrated mills.

**Exhibit 3: North American Service Center Shipments and Inventory Levels**



Source: Metals Service Center Institute, Raymond James Ltd

- Energy Markets a Bright Spot.** For several years natural gas prices were an important leading indicator of Russel’s Energy Tubular segment’s performance. But with the recent explosion of non-conventional oil and gas developments this relationship has started losing some of its relevance. Nowadays, rig counts—which coincidentally are at near record levels—provide a much better representation of OCTG demand (see Exhibit 4). That’s because E&P companies use more and better quality pipes when they need to drill holes horizontally. And with a long list of oil sands projects getting underway in and around the Fort McMurray region, we believe that much upside resides in Russel’s energy business.

**Exhibit 4: North American Rig Counts (12-month moving average) and Composition (percent)**

Source: Baker Hughes, Raymond James Ltd.

- ◆ **M&A Activity Picking Up.** 2004 marked a watershed year for the steel sector as surging prices ignited a period of intense M&A activity. Steel producers merged not only for the sake of becoming bigger, but also to better withstand periods of hardship. Although the sector has consolidated significantly since those days, there is still a healthy level of transactions happening today. For proof, consider that in recent months: (i) Carl Icahn announced a US\$1.73 bln hostile takeover for Commercial Metals; (ii) A.M. Castle acquired Houston-based Tube Supply for US\$165 mln (the move will position the firm to further capitalize on the growing oil and gas sector); (iii) Ryerson acquired service centre operator Turret Steel Industries (iv) Optima Group acquired cold-finished bar producer Niagara LaSalle from private equity firm Kohlberg & Co; and, (v) ailing Ontario-based steel pipe and tubing maker Lakeside Steel received a non-binding letter of intent from an undisclosed buyer for \$77.5 mln. Having said all this, we see most metals service centers in operations today as either in the “mom and pop” category or owned by strategic investors awaiting the next up cycle to cash out. Unfortunately for Russel Metals, this leaves very little to pick from.

## Appendix: Peer Group Valuation

Company Name	Ticker	Fx	FY END	Market Price	Shares O/S (mln)	Market Cap (mln)	Net Debt (mln)	Ent. Value (mln)	P / E			EV / EBITDA			Net Debt/ Cap (%)	Price /Book (x)	Div. Yield (%)	RJL Rating
									2010A	2011E	2012E	2010A	2011E	2012E				
<b>STEEL FABRICATORS &amp; PROCESSORS</b>																		
ADF GROUP INC.	DRX.CA	CAD	JAN	\$1.28	33.3	\$43	(\$19)	\$24	11.7	17.4	20.4	2.2	3.5	3.3	n.m.	0.5	1.6	OP2
CANAM GROUP INC	CAM.CA	CAD	DEC	\$3.81	45.4	\$173	\$257	\$430	n.m.	n.m.	19.1	n.m.	n.m.	8.5	59.8	0.5	0.0	MP3
GIBALTAR INDUSTRIES	ROCK.US	USD	DEC	\$14.25	30.4	\$433	\$174	\$607	n.m.	20.4	15.6	14.3	7.2	4.8	28.6	n.m.	--	nc
VICWEST INC.	VIC.CA	CAD	DEC	\$9.05	17.2	\$156	\$87	\$243	11.6	14.6	9.2	11.4	9.3	6.5	35.9	2.8	7.3	nc
									11.7	17.5	16.1	9.3	6.7	5.8				
<b>SERVICE CENTERS</b>																		
AM CASTLE & CO.	CAS.US	USD	DEC	\$9.28	23.0	\$214	\$78	\$292	n.m.	14.8	6.7	n.m.	9.0	3.3	26.7	0.7	--	nc
CARPENTER TECHNOLOGY CORP.	CRS.US	USD	JUN	\$52.55	44.2	\$2,322	\$92	\$2,414	n.m.	20.5	14.9	14.8	8.5	7.3	3.8	3.0	1.4	nc
METALS USA HOLDINGS CORP	MUSA.US	USD	DEC	\$11.51	37.1	\$427	\$472	\$898	25.0	6.8	6.2	11.0	5.7	5.3	52.5	2.2	--	nc
RELIANCE STEEL & ALUMINUM CO.	RS.US	USD	DEC	\$49.43	75.0	\$3,706	\$1,387	\$5,093	18.9	11.1	9.5	10.6	7.3	6.2	27.2	1.3	1.0	nc
RUSSEL METALS	RUS.CA	CAD	DEC	\$22.24	66.9	\$1,487	(\$96)	\$1,391	19.1	11.9	10.6	9.5	6.4	5.9	n.m.	1.6	5.4	OP2
WORTHINGTON INDS INC	WOR.US	USD	MAY	\$17.07	70.6	\$1,205	\$433	\$1,638	11.5	10.9	8.9	9.1	8.7	9.7	26.4	1.8	2.9	nc
									18.6	12.7	9.5	11.0	7.6	6.3				
<b>STEEL PRODUCERS</b>																		
AK STEEL HOLDING CORP.	AKS.US	USD	DEC	\$8.15	110.3	\$899	\$887	\$1,786	n.m.	n.m.	9.7	11.7	7.4	4.5	49.7	1.4	2.5	nc
ALLEGHENY TECHNOLOGIES	ATI.US	USD	DEC	\$48.44	106.4	\$5,152	\$1,197	\$6,349	n.m.	19.5	13.2	n.m.	9.2	6.5	18.9	2.3	1.6	nc
COMMERCIAL METALS COMPANY	CMC.US	USD	AUG	\$14.18	115.5	\$1,638	\$1,181	\$2,819	n.m.	12.7	8.1	10.7	6.8	5.3	41.9	1.4	3.4	nc
NUCOR CORPORATION	NUE.US	USD	DEC	\$40.11	316.7	\$12,703	\$1,874	\$14,577	n.m.	17.2	13.1	14.0	7.5	6.2	12.9	1.8	3.7	nc
OLYMPIC STEEL INC.	ZEUS.US	USD	DEC	\$25.20	10.9	\$275	\$249	\$523	n.m.	10.5	9.3	n.m.	8.3	7.0	47.5	1.0	0.3	nc
STEEL DYNAMICS INCORPORATED	STLD.US	USD	DEC	\$13.15	218.7	\$2,876	\$1,924	\$4,799	19.6	10.9	8.8	8.0	5.8	5.1	40.1	1.4	3.1	nc
US STEEL CORP.	X.US	USD	DEC	\$25.99	144.0	\$3,743	\$3,663	\$7,406	n.m.	n.m.	10.3	13.5	6.9	4.8	49.5	1.0	0.8	nc
									19.6	14.2	10.3	11.6	7.4	5.6				
<b>BLENDED GROUP AVERAGE</b>																		
									16.6	14.8	12.0	10.6	7.2	5.9				

Notes:

1) Estimates for ADF Group, Canam Group and Russel Metals are from Raymond James; all other estimates are consensus from Thomson One.

2) P/E and EV/EBITDA multiples presented for ADF Group are for the fiscal years ending Jan-31-10, Jan-31-11 and Jan-31-12.

Source: Thomson One, Raymond James Ltd.

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**Growth (G)** Low to average risk equities with sound financials, more consistent earnings growth, possibly a small dividend, and the potential for long-term price appreciation.

**Aggressive Growth (AG)** Medium or higher risk equities of companies in fast growing and competitive industries, with less predictable earnings and acceptable, but possibly more leveraged balance sheets.

**High Risk (HR)** Companies with less predictable earnings (or losses), rapidly changing market dynamics, financial and competitive issues, higher price volatility (beta), and risk of principal.

**Venture Risk (VR)** Companies with a short or unprofitable operating history, limited or less predictable revenues, very high risk associated with success, and a substantial risk of principal.

## Rating Distributions

	Coverage Universe Rating Distribution			Investment Banking Distribution		
	RJL	RJA	RJ LatAm	RJL	RJA	RJ LatAm
<b>Strong Buy and Outperform (Buy)</b>	71%	59%	44%	47%	16%	20%
<b>Market Perform (Hold)</b>	28%	36%	49%	26%	7%	3%
<b>Underperform (Sell)</b>	1%	6%	7%	0%	14%	0%

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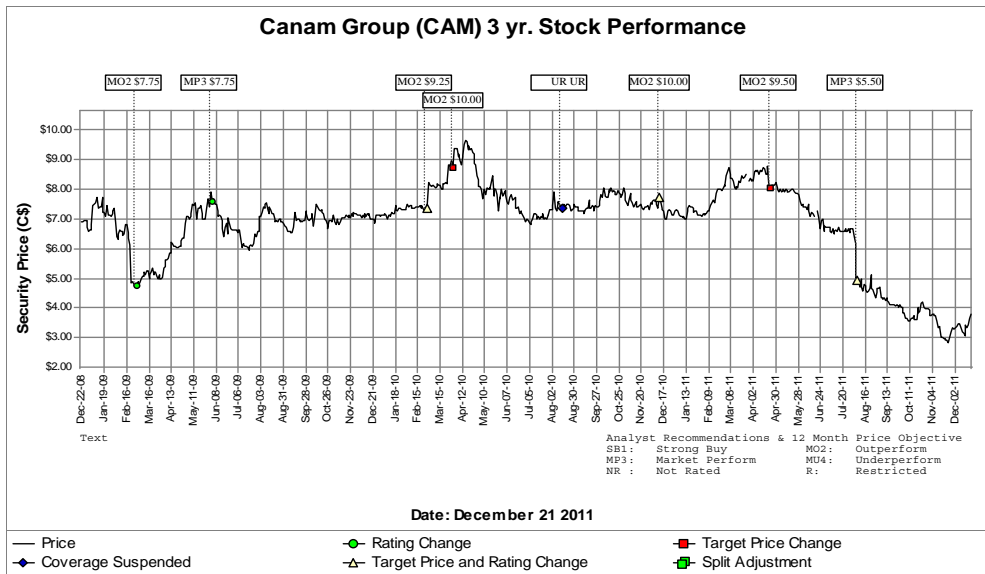
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## Stock Charts, Target Prices, and Valuation Methodologies

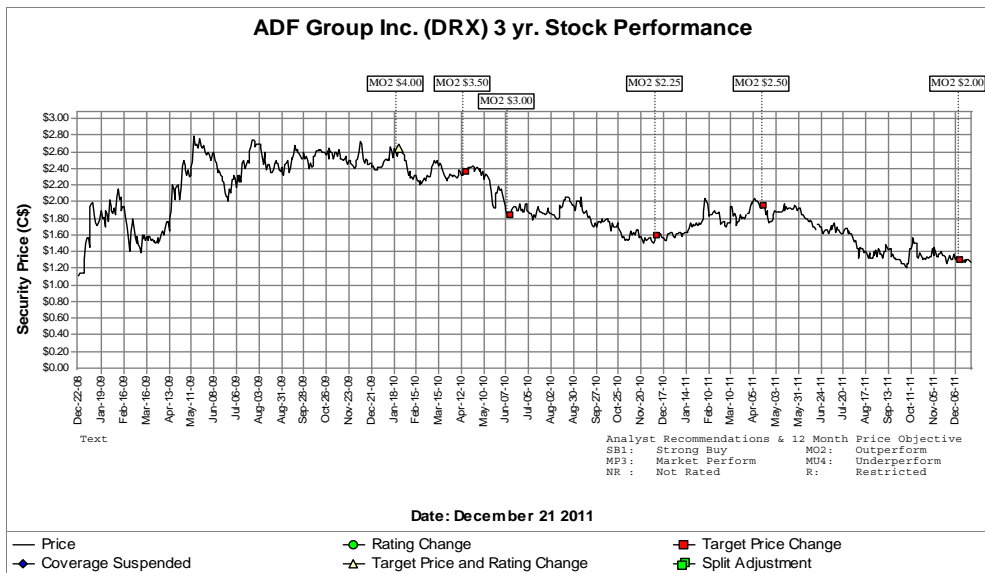
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**Target Prices:** The information below indicates target price and rating changes for the subject companies included in this research.



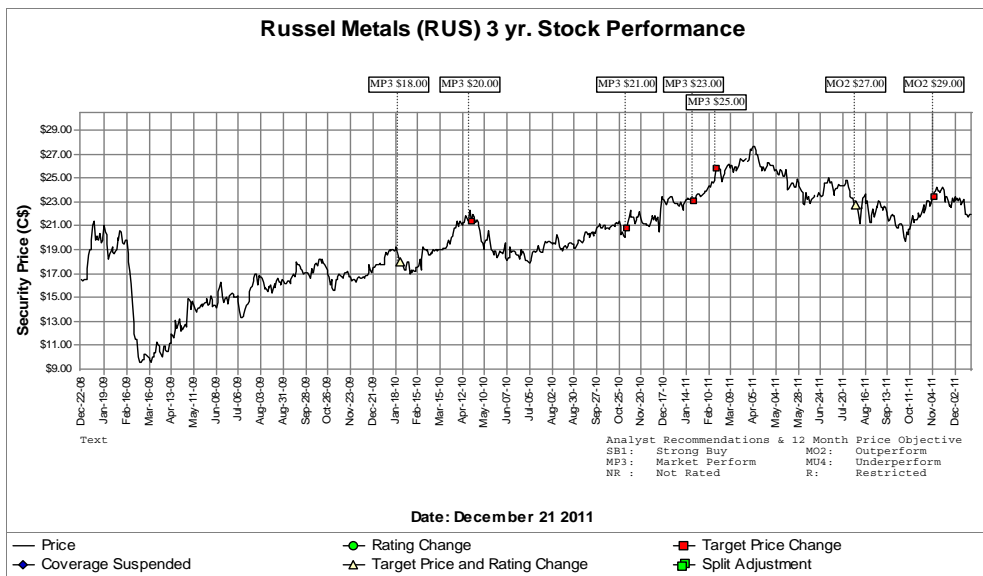
Update Date	Closing Price	Target Price	Rating
Aug-05-11	4.92	5.50	3
Apr-26-11	8.05	9.50	2
Dec-11-10	7.74	10.00	2
Aug-13-10	7.35	UR	UR
Mar-31-10	8.74	10.00	2
Feb-25-10	7.35	9.25	2
Jun-02-09	7.58	7.75	3
Feb-27-09	4.77	7.75	2

**Valuation Methodology:** We value Canam on a comparative basis to historical multiples.



Update Date	Closing Price	Target Price	Rating
Dec-09-11	1.31	2.00	2
Apr-15-11	1.96	2.50	2
Dec-10-10	1.60	2.25	2
Jun-10-10	1.85	3.00	2
Apr-16-10	2.36	3.50	2
Jan-22-10	2.65	4.00	2

**Valuation Methodology:** We value ADF Group on a comparative basis to peer historical multiples, taking into account ADF's smaller capitalization and concentrated customer base.



Update Date	Closing Price	Target Price	Rating
Nov-04-11	23.38	29.00	2
Aug-04-11	22.74	27.00	2
Feb-18-11	25.84	25.00	3
Jan-25-11	23.12	23.00	3
Nov-03-10	20.76	21.00	3
Apr-22-10	21.43	20.00	3
Jan-22-10	18.01	18.00	3

**Valuation Methodology:** We value Russel Metals on a comparative basis to historical multiples.

**Risk Factors**

**General Risk Factors:** Following are some general risk factors that pertain to the projected target prices included on Raymond James research: (1) Industry fundamentals with respect to customer demand or product / service pricing could change and adversely impact expected revenues and earnings; (2) Issues relating to major competitors or market shares or new product expectations could change investor attitudes toward the sector or this stock; (3) Unforeseen developments with respect to the management, financial condition or accounting policies or practices could alter the prospective valuation.

**Risks - Canam Group**

(i) The company’s fortunes are closely linked to the wellbeing of both the Canadian and U.S. economies and the regional markets in which it operates; thus a sustained downturn in one or more markets could adversely impact the company; (ii) the company faces competitive pressures from companies that have greater financial and operating resources; (iii) construction operations are highly weather dependent; (iv) roughly 45% of the company’s workforce is unionized or governed by industry-wide field agreements, exposing the company to potential labour disruptions; (v) the company is exposed to currency risk since roughly half of its sales are denominated in foreign currencies; (vi) the company is also exposed to various litigation, environmental and safety risks; (vii) volatility in the price of raw materials could impact profitability, and (viii) certain assets and liabilities appearing on the company’s balance sheet may not reflect their fair or market value.

**Risks - ADF Group**

(i) ADF's operations are linked to general economic condition, and more specifically, to the North American non-residential construction industry. The deterioration of either could adversely affect the company's business activity; (ii) ADF competes against companies with greater access to capital and other resources, possibility reducing ADF's overall competitiveness and market share; (iii) since significant amounts of working capital are required in the day to day operations of the company, reduced access to capital could adversely affect the corporation's business; (iv) the majority of ADF's sales are denominated in U.S. dollars while a significant portion of operating expenses and capital expenditures are denominated in Canadian dollar, therefore exposing the company to currency exchange risk; (v) ADF's primary raw material is steel, the price, quality and delivery of which can fluctuate significantly resulting in uncertain operating results; (vi) to the extent the company relies heavily on the management and leadership of its senior management team along with skilled tradesmen, it is imperative for ADF to attract and retain its executives and employees; (vii) ADF relies on a small number of customers each representing over 10% of annual revenues; the loss or failure to replace such a customer could adversely affect the company's operations; (viii) The Paschini family controls the majority of voting rights in the company through ownership of multiple voting shares, and is in a position to affect the governance and operations of the company; (ix) the company is subject to labour strikes and unsuccessful collective bargaining renegotiations that could negatively impact operational efficiency. Additional risks to which ADF is exposed include: (x) the financial strength (or lack thereof) of suppliers and customers along the value chain; (xi) tightening credit conditions; (xii) performance of subcontractors; (xiii) access to bonding; (xiv) exposure to various litigation, environmental, weather, safety and regulatory risks.

**Risks - Russel Metals**

(i) Russel's revenues are predominately derived from the sale of steel and specialty metals, the price and availability of which can fluctuate significantly resulting uncertain operating results, and possible write-downs of inventories to net realizable value; (ii) the company relies heavily on the management and leadership of its senior executive team. As such, it is imperative for Russel to be able to attract and retain executives; (iii) any future acquisitions may involve debt incurrence, dilutive equity issuance and significant cash expenditures, which could result in a deterioration of Russel's financial condition, results of operations and cash flows; (iv) Russel competes against other service centres, and in some cases, directly with steel producers. Such competitors may have lower raw material costs than Russel, therefore, reducing Russel's market share and financial performance in those regions; (v) a portion of the company's sales and operating costs are denominated in U.S. dollars, therefore exposing the company to currency exchange risk. Strength in the Canadian dollar relative to other currencies, namely the U.S. dollar, may benefit competitors who primarily operate in non-Canadian currencies; (vi) Russel's operations are linked to the overall business cycle and to the pricing of natural gas; (vii) the company is subject to labour strikes and unsuccessful collective bargaining renegotiations which could negatively impact operational efficiency. Additional risks Russel is exposed to include: (viii) the financial strength (or lack thereof) of suppliers and customers along the value chain; (ix) tightening credit conditions; (x) exposure to various litigation, environmental, weather, safety and regulatory risks.

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