STANDARD & POOR'S

# P.I.E. Industrial

Recommendation: **BUY**

Stock Code: **7095** Bloomberg: **PIE MK** Price: **MYR2.53** 12-Month Target Price: **MYR2.85** Date: **March 16, 2006**

**Board:** Main

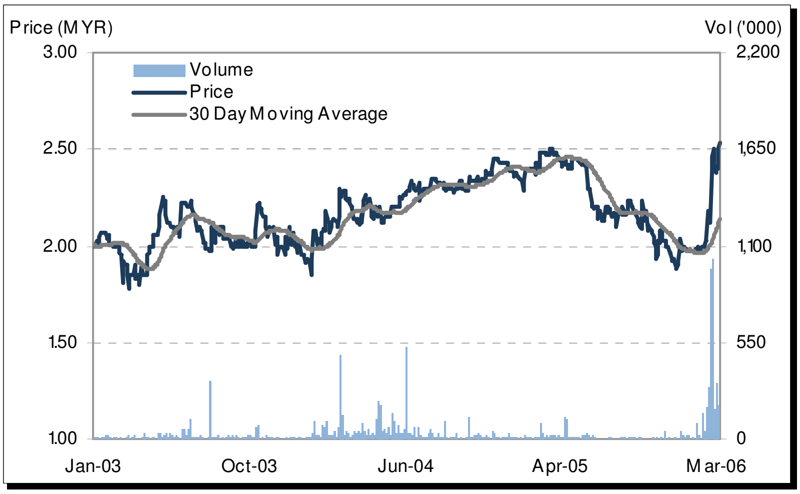
**Sector:** Industrial products

**GICS**: Industrials / Electrical Components & Equipment

**Market Capitalization:** MYR156.9 mln

**Summary:** P.I.E. Industrial Berhad's (PIE) principal activities are the contract manufacturing of industrial electronics devices, and the production and assembly of cables and wires. Other activities include trading of electronic products.

**Analyst:** Christopher Lee




## Highlights

- We forecast the group's net profit for 2006 to increase by 9% to MYR18.5 mln due to the full year contributions from its Thai subsidiary. For 2007, we forecast net profit will grow by 7% to MYR19.8 mln due to a slower increase in new orders for the contract equipment manufacturing (CEM) business and a decline in the margin for CEM due to competition. We are cautious about the outlook for its Thai subsidiary due to its volatile earnings history and a lack of disclosure and transparency.

## Investment Risks

- Risks to our recommendation and target price include stronger-than-expected competition in the CEM market, which could result in a lower-than-expected margin and a loss of CEM orders from key customers.

## Recommendation

- We initiate coverage on PIE with a Buy recommendation. Our 12-month target price is MYR2.85, derived by ascribing a 9x PER multiple on our 2006 earnings forecast, plus 2006 dividends of MYR0.18 (tax exempt), which suggests a 13% upside potential based on the current share price. We believe the stock's PER multiples could recover modestly given our expectations for earnings to rebound to the last record level since its listing.

- We believe PIE deserves to trade at premium to the target PER of 8x that we have used to value Comintel Corporation (Comcorp, CMT MK, Strong Sell), its local OEM peer, due to the group's better earnings growth profile and higher ROEs. PIE is forecast to post 2005-2007 CAGR of 8.0%, vs. Comcorp's FY05-07 CAGR of –42.1%. The group's ROE will be 11.9% in 2006 and 2007, vs. Comcorp's 1.4% and 3.8%.

- We believe one of the key attractions of the group is the dividend payout. The group has continued to pay out 44-98% of its earnings in 2002-04. We forecast the group's dividend payout to increase to 60% in 2005-06, which would translate to gross yields of 7-8% per annum, given its excess cash and limited capex for 2006-2007.

### Key Stock Statistics

| FY Dec. | 2005 | 2006F |
|---|---|---|
| EPS (sen) | 27.5 | 29.6 |
| PER (x) | 9.2 | 8.5 |
| Dividend/Share (sen) | 12.0 | 18.0 |
| NTA/Share (MYR) | 2.39 | 2.57 |
| Book Value/Share (MYR) | 2.42 | 2.60 |
| Issued Capital (mln shares) | 62.0 | |
| 52-week Share Price Range (MYR) | 1.89 - 2.51 | |
| Major Shareholders: | % | |
| Pan Global Holding Co. Ltd | 53.6 | |
| Lembaga Tabung Haji | 7.8 | |

### Per Share Data

| FY Dec. | 2003 | 2004 | 2005 | 2006F |
|---|---|---|---|---|
| Book Value (MYR) | 2.13 | 2.19 | 2.42 | 2.60 |
| Cash Flow (sen) | 21.4 | 27.2 | 31.8 | 41.6 |
| Earnings (sen) | 12.4 | 18.3 | 27.5 | 29.6 |
| Dividend (sen) | 12.0 | 12.0 | 12.0 | 18.0 |
| Payout Ratio (%) | 98.4 | 66.1 | 43.9 | 60.4 |
| PER (x) | 20.4 | 13.8 | 9.2 | 8.5 |
| P/Cash Flow (x) | 11.8 | 9.3 | 8.0 | 6.1 |
| P/Book Value (x) | 1.2 | 1.2 | 1.0 | 1.0 |
| Dividend Yield (%) | 4.7 | 4.7 | 4.7 | 7.1 |
| ROE (%) | 5.8 | 8.5 | 11.9 | 11.9 |
| Net Gearing (%) | 0.0 | 0.0 | 0.0 | 0.0 |

## Background

**Corporate Profile**

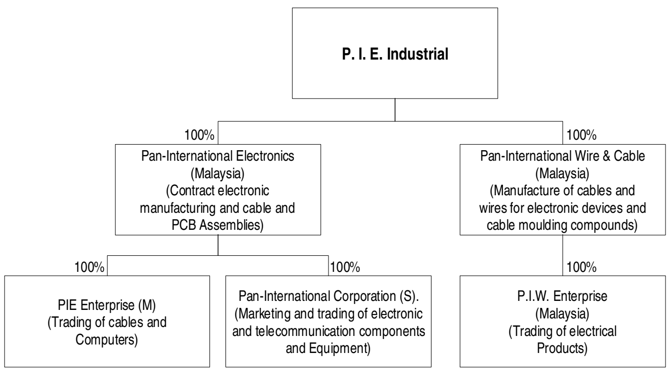
PIE's principal activities are the contract manufacturing of industrial electronics devices and the production and assembly of cables and wires, through its production facilities in Penang, Malaysia. Other activities include the trading of electronic products, such as handset earphones, and PC peripherals.

PIE is listed on the Main Board of Bursa Malaysia. Pan Global Holding Co. Ltd. (unlisted) is the holding company of PIE with a 53.6% stake. Taiwan's Pan-International Industrial Corporation (2328 TT, Not Ranked) has a 100% stake in Pan Global Holding. In addition, Lembaga Tabung Haji (7.8%) and Allianz General Insurance Malaysia (4.9%) are also major shareholders.

Y.T.M. Tunku Dato' Dr. Ismail Ibni Almarhum Tunku Mohd Jewa (Dr. Ismail) is the Chairman and Non-Executive Director. He was appointed to the Board in June 1997. Dr Ismail is also a Director of Oriental Holdings (OHB MK, Not Ranked), Luster Industries (LSTI MK, Not Ranked), and CAB Cakaran Corporation (CABC MK Not Ranked).

We have found no significant corporate governance issues with the group. Related party transactions are insignificant as they accounted for 1.9% of group revenue for 2004. However, as independent directors comprise two out of six on the board seats, we believe the composition of the Board of Directors can be improved.

**Corporate Structure**




Source: Company data

**Business**

***Manufacturing***

PIE's core businesses are CEM and the production of raw wires and cables. Its CEM business constituted around 60% of group revenue in 2002-2005. PIE provides CEM services in three areas: industrial electronics, consumer electronics, and PC peripherals. According to management, industrial electronics has been the key revenue contributor since 2004, accounting for 70% of CEM revenue. Management plans to further grow the industrial electronics business (e.g. barcode scanners, industrial battery packs and chargers, and industrial control and sensor devices), due to higher margins of customized products in this segment.

PIE's CEM business has recovered following a decline in 2002 when the group lost orders from its largest customer, Xircom (unlisted). Revenue grew by 33% YoY and 29% YoY to MYR92.5 mln and MYR118.8 mln in 2004 and 2005 respectively. According to management, PIE has secured OEM orders from several new customers, such as PSC (unlisted) and IO-YT (unlisted), leading to a turnaround in the group's top line. We forecast CEM revenue to grow by 11.3% and 10.7% to MYR132.3 mln and MYR146.4 mln in 2006 and 2007, respectively, vs MYR118.8 mln for 2005. We expect slower growth in new orders going forward as the group is already one of the largest suppliers to its CEM customers, and its efforts to develop new customers have shown limited headway.

In our view, OEM customers generally maintain multiple suppliers to ensure bargaining power and better delivery terms. Currently, the group is the only CEM for IO-YT, and accounts for around 70% of PSC's outsourcing orders, according to management. We believe the future growth for CEM will depend on new customers. Although the group has spent the last two years cultivating new customers, there are no signs of a breakthrough as yet.

PIE is also engaged in the manufacturing of raw wires and cables. These products are mainly used in telecommunications, computers, consumer electronics, and industrials (e.g. automotive and medical). The revenue of the wire and cable division grew at a three-year CAGR of 8% for 2001-2004. We forecast revenue to increase by 7% and 6% in 2006 and 2007, respectively, tracking the industry growth rate. According to MindBranch, a market research source, the global wire and cable industry is expected to grow at mid-single digit rates for 2005-08 vs 4.2% for 2005.

We forecast EBIT margin of the manufacturing division to drop to 11.2% and 11.0% in 2006 and 2007, respectively. We note that the division's EBIT margin has increased to 11.4% in 2005, vs. 10.7% in 2004, due to contributions from higher-value industrial electronic products. According to management, EBIT margin of industrial electronics was estimated at 13%, vs. less than 10% for consumer electronics and PC peripherals. However, we believe the higher margin for industrial electronics is not sustainable due to ongoing pressure from competitors. The group's other products (i.e. PC peripherals and consumer electronics) have also experienced a similar trend in margin compression due to competition in the past.

***Thailand***

PIE acquired Pan International Electronics (Thailand) Co. Ltd from its majority shareholder, Pan Global Holding in Nov. 2005. The Thai plant assembles wires and cables and their main applications include teleconferencing devices, and home appliances (e.g. air conditioners, microwaves, etc.).

We note that the group's Thai subsidiary has significant volatility in its operating results and this could be due to customer changes. Revenue was largely flat in 2002-2003, following a 46% decrease to MYR16.6 mln in 2001. Revenue then rebounded sharply in 2004 (38% YoY growth to MYR21.6 mln) and remained flat at MYR21.6 mln (-1.0% YoY) in 2005. In addition, its EBIT margins also ranged between 2-21% in 2001-2005, due to changes in the product mix. According to management, its target market has switched from PC peripherals (2001), to industrials (2002-2003) and teleconferencing devices (2004-2005).

We are cautious about the outlook of the Thailand subsidiary, due to its volatile earnings history and a lack of transparency. We believe the product mix changes in recent years could be due to the group's inability to retain its customer base. We forecast the Thai subsidiary's revenue will grow by 6% in 2006 and 2007, in line with its 4-year CAGR in 2001-2005. Margin-wise, we forecast the EBIT margins will be 9.7% in 2006, its average in 2001-2005, and drop to 9.4% in 2006 due to competitive pressure for the commodity-like products.

***Trading***

PIE is involved in the trading of electronics products, such as bluetooth handset earphones, optical disc drives (including CD-RW, DVD-ROM, and DVD-RW), and PC peripherals (i.e. printers, monitors). The revenue of the trading division turned-around in 4Q04, and grew by 72% YoY to MYR23.3 mln in 2005, due to a lower base in 2004 and a change in strategy to price discounting. We forecast revenue will grow by 8% and 7% to MYR25.2 mln and MYR27.0 mln in 2006 and 2007, respectively, as price discounting is unlikely to increase revenue significantly given a competitive trading environment. EBIT margin of this division dropped to 1.9% in 2005 from 2.5-3.0% in 2002-2004, and we forecast EBIT margin at 1.0% for 2006-2007.

## Earnings Outlook

We forecast PIE's 2006 revenue to grow by 19.0% YoY to MYR242.4 mln, largely due to the full year contribution from its Thai subsidiary. We estimate Thailand's revenue will reach MYR22.9 mln and account for 9% of the group's 2006 revenue. Manufacturing and trading revenue are expected to grow by 10% YoY and 8% YoY to MYR194.3 mln and MYR25.2 mln, respectively. For 2007, we forecast the group revenue will grow by 8.6% YoY to MYR263.3 mln, with Malaysian revenue growing by 8.9% (9% growth for manufacturing and 7% growth for trading) and Thailand revenue growing by 6.0%.

We expect the group's EBIT margin will drop to 10.0% and 9.8% in 2006 and 2007 respectively, vs. 10.6% in 2005. PIE has maintained its EBIT margins at 9.0-9.5% in 2002-2004. We believe the higher margin in 2005 is attributed to the contribution from high-value industrial electronics products, which we forecast to decline going forward due to competition. We forecast the group's net profit to improve by 9.1% and 6.9% to MYR18.5 mln and MYR19.8 mln, respectively.

PIE had net cash of MYR55.2 mln at end-2005. Total capex was MYR20.3 mln (or MYR5.8 mln excluding the acquisition of its Thai subsidiary) in 2005. We expect capex will be MYR6.1 mln and MYR6.3 mln in 2006 and 2007, mostly for the upgrading of the facilities of the CEM division. We do not expect any significant capex for capacity, given current utilization rates of 60-70% based on a single shift. We believe PIE can internally fund its capex even after paying out more than 70% of its earnings in dividends, due to its stable operating cash flows and net cash position.

We believe one of the key attractions of the group is the dividend payout. The group has continued to pay out over 44-98 of earnings in 2002-2005. We forecast the group's dividend payout to increase to 60% in 2006-07 given its excess cash position and limited capex in 2006-07.

## Valuation

Our 12-month target price of MYR2.85 is derived from ascribing a 9x PER multiple to our 2006 estimate, plus forecast 2006 tax exempt dividends of MYR0.18. Our target price suggests an upside potential of 13% based on the current share price.

We believe PIE deserves to trade at premium to the target PER of 8x that we have used to value Comcorp, its local OEM peer manufacturing similar products, due to the group's better earnings growth profile and higher ROEs. PIE is forecast to post 2005-2007 CAGR of 8.0%, vs. Comcorp's FY05-07 CAGR of –42.1%. In addition, the group's ROE will be 11.9% in 2006 and 2007, vs. Comcorp's 1.4% and 3.8%.

The valuation of PIE has been de-rated from an average PER of 16.4x in 2003, due to a lack of broad customer base and a competitive CEM market. The stock is currently trading at 8.5x PER and 0.92x P/BV based on our 2006 estimates, vs. its trough valuation of 7.5x PER and 0.85x P/BV, respectively.

We believe the stock's PER multiples, which are hovering near historical lows, could recover modestly given our expectations for earnings to rebound to the last record level since its listing. We believe our earnings growth forecast of 9% and 7% for 2006 and 2007, respectively, are relatively secure as we have assumed no significant new customers for the CEM business and the Thai subsidiary's profit to normalize following a record year in 2005.

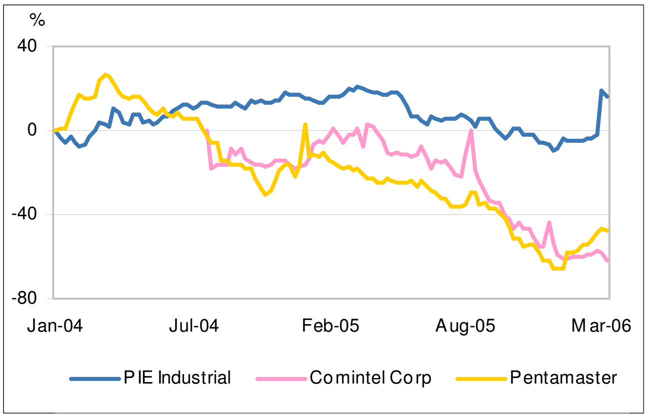
### Comparative Valuation

| | PIE | COMCORP* | PENTA** |
|---|---|---|---|
| Share Price (MYR) @ Mar 15, 06 | 2.53 | 0.32 | 1.35 |
| Mkt. Cap (MYR mln) | 156.9 | 44.8 | 167.9 |
| Ave. Daily Vol. ('000) | 101 | 43 | 611 |
| PER FY04 (x) | 13.8 | 5.1 | 11.9 |
| PER FY05 (x) | 9.2 | 2.0 | 10.9 |
| P/NTA | 1.1 | 0.4 | 1.7 |
| Yield (%) | 4.7 | 32.2 | 3.7 |

** COMCORP, FY04 (Jan.) and FY05 (Jan.)*
*** PENTA =Pentamaster Corporation (PENT MK, Not Ranked)*

Source: Bloomberg, Company data

### Relative Share Price Performance of Comparables




Source: Bloomberg, S&P Equity Research

## Recent Developments

Sep. 2005: Received approval from Bank Negara Malaysia for the proposed acquisition of entire issued and paid-up share capital of Pan International Electronics (Thailand) Co. Ltd. for MYR14.5 mln, which is expected to be completed by end of 2005.

Oct. 2005: Proposed the disposal of Prubond Fund for MYR13.5 mln.

# P.I.E. Industrial

Recommendation: **BUY**

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## Profit & Loss

| FY Dec. / MYR mln | **2004** | **2005** | **2006F** | **2007F** |
|---|---|---|---|---|
| Revenue | 154.1 | 203.7 | 242.4 | 263.3 |
| Operating Profit (EBIT) | 14.4 | 21.6 | 24.2 | 25.9 |
| Depreciation | -5.4 | -2.7 | -7.5 | -7.3 |
| Net Interest Income / (Expense) | -0.2 | -0.2 | -0.2 | -0.2 |
| Pretax Profit | 14.2 | 21.3 | 24.0 | 25.7 |
| Effective Tax Rate (%) | 21.7 | 20.5 | 23.0 | 23.0 |
| Net Profit | 11.1 | 16.9 | 18.5 | 19.8 |
| Operating Margin (%) | 9.3 | 10.6 | 10.0 | 9.8 |
| Pretax Margin (%) | 9.2 | 10.5 | 9.9 | 9.8 |
| Net Margin (%) | 7.2 | 8.3 | 7.6 | 7.5 |

Source: Company data, S&P Equity Research

## Balance Sheet

| FY Dec. / MYR mln | **2003** | **2004** | **2005** |
|---|---|---|---|
| Total Assets | 153.9 | 167.2 | 188.1 |
| Fixed Assets | 41.7 | 37.9 | 49.5 |
| Current Assets | 95.3 | 127.8 | 134.8 |
| Other LT Assets | 16.9 | 1.6 | 3.8 |
| Current Liabilities | 21.9 | 29.5 | 32.4 |
| LT Liabilities | 3.8 | 3.7 | 5.6 |
| Share Capital | 60.1 | 61.2 | 62.0 |
| Shareholders' Funds | 128.2 | 134.1 | 150.2 |

Source: Company data, S&P Equity Research

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**Glossary**

**Strong Buy:** Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.
**Buy:** Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.
**Hold:** Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.
**Sell:** Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.
**Strong Sell:** Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

**S&P 12 Month Target Price** – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

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