K & N Kenanga Research

[PP7004/11/2006] ● 14 April 2006

Company Report
P.I.E. Industrial Berhad
Exciting Growth Prospects Ahead

BUY RM2.55
Initiating Coverage
Target RM3.28
BMCI: 936.24

- **PIE is part of the Hon Hai Precision Industrial Ltd ("Hon Hai") group, the world's largest electronic manufacturing services ("EMS") company.** It benefits from having access to the latest technology and R&D of the group both in product development as well as manufacturing processes giving it the edge over its competitors. It does not spend on R&D but is charged for services it utilized from the group's R&D centers.
- **PIE can also tap into Hon Hai's customer base, world-renown brands in computers, communications and consumer electronics.** In addition, potential customers are also more confident of PIE given Hon Hai group's track record of high quality products and timeliness in meeting deadlines.
- **Economy of scale in acquiring raw materials being part of the Hon Hai group,** gives PIE the advantage in cost competitiveness against its peers. This is critical in maintaining margins as the customers would continue to ask for lower prices as the product lifespan ages. In addition, despite being able to pass on the higher polymer and copper cost to its customers, PIE the has benefit of global sourcing of raw materials ensuring stable supply at the best price.
- **Growth will be derived from securing more new customers. PIE's strong growth in FY05 was a result of securing 3 new customers for its contract electronic manufacturing ("CEM") division.** Its customer diversification also broadened its product categories reducing its exposure to the volatility in the computer sector.
- **It has the capacity to do more.** Currently its CEM division is operating on one shift and can easily increase capacity without incurring large capital expenditure to meet increase orders. It is close to securing another 5 new customers, which they have been negotiating with over the past two years. The long gestation period signify the high barrier to entry into large MNC customers.
- **PIE is currently trading at 6.1x FY06 P/E multiples compared Hon Hai's 13.8x.** Both Taiwan and Malaysian FY06 market P/E multiples are similar at 15x and 14x respectively. Given the high growth potential of PIE, we believe our valuation using an 8x PE multiple and FY06E EPS of 41 sen is conservative, translating to valuation of RM3.28 or an upside of 29%.

YE 31 Dec (RM'000)	2004A	2005A	2006E	2007E	2008E
Total Revenue	154,124	203,680	262,450	300,417	343,939
EBITDA	19,791	24,239	36,310	38,964	44,465
Pretax Profit	14,198	21,322	32,994	35,434	40,720
Net Profit	11,111	16,950	25,736	27,638	31,762
EPS (sen)	0.178	0.271	0.412	0.442	0.508
EPS Growth (%)	49.4%	52.6%	51.8%	7.4%	14.9%
PER (x)	14.3	9.4	6.1	5.8	5.0
ROE (%)	8.3%	11.3%	16.2%	16.4%	17.7%
GDPS (sen)	0.12	0.18	0.27	0.29	0.34
Dividend Yield (%)	4.7%	7.1%	10.7%	11.5%	13.2%

Other Key Data

Market Cap.	RM158.2m
Issued Shares	62.046m
Est. Free Float	24.28%
Major S'holders	Pan Global Holdings Co (53.57%)
	Lembaga Tabung Haji (7.81%)
	Allianz (11.03%)
	LTAT (3.26%)
Reuters	PIE.KL
Bloomberg	PIE MK

The Research Team (03) 2166 6822

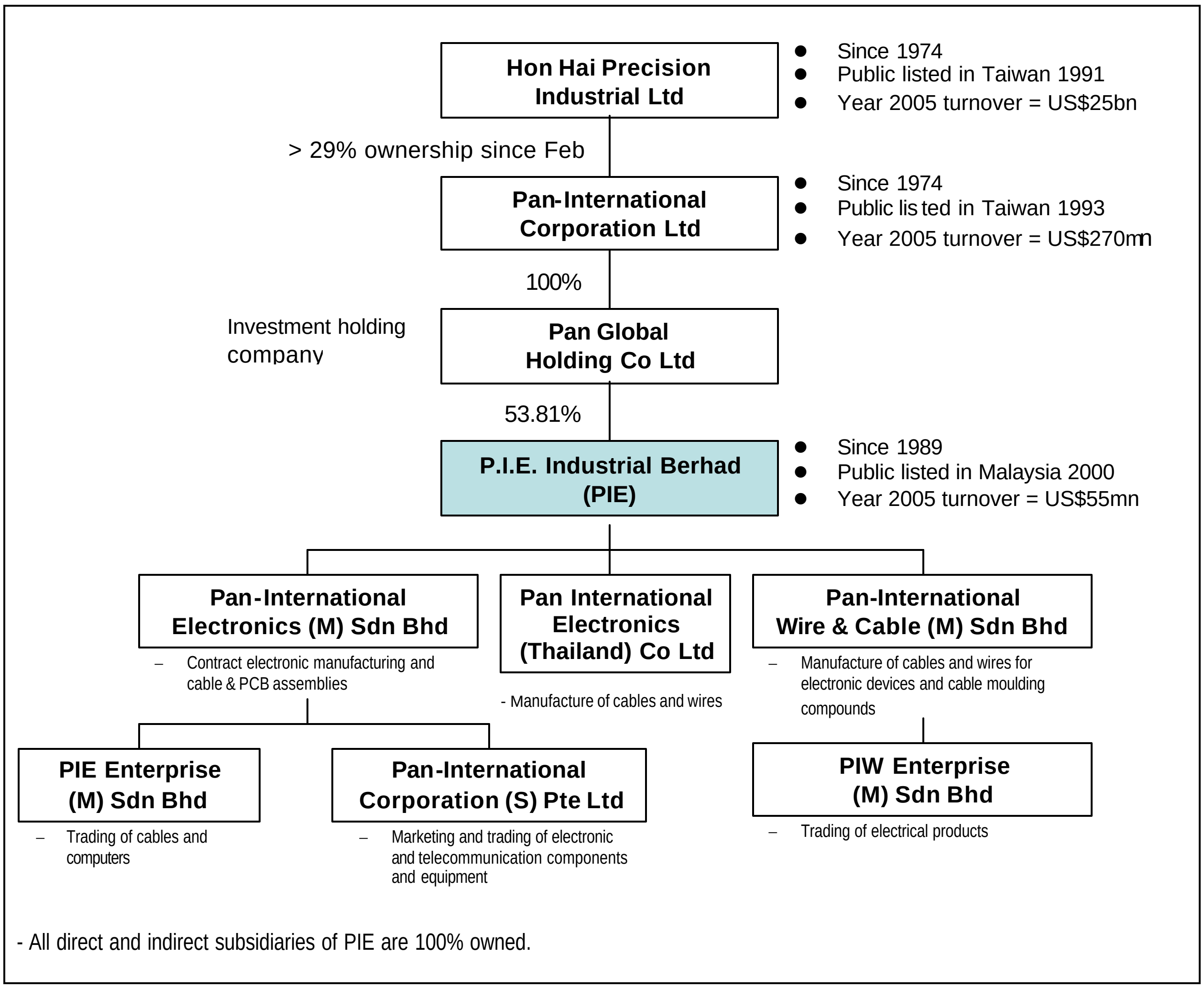
Background & Business

Integrated CMS company with presence in Malaysia and Thailand servicing South East Asia

PIE's principal activities are the contract electronic manufacturing ("CEM") of electronic devices/components for the 3C (computers, communication and consumer electronics) and the production/ assembly of cables and wires (for computers, telecommunication and other specialised uses) at its production facilities in Penang and Thailand. Other activities include the trading of electronic products including handset earphones, AV products and PC peripherals.

Its corporate structure is as follows:

Corporate Structure of PIE



Long established track record with multinational companies

PIE commenced operations in 1989 in a rented factory with 100,000 sq ft and RM5 million paid-up capital. Today, it has a total factory built up space of 131,000 sq ft and 283,140 sq ft for the cable/wire assembly and CEM divisions respectively. It completed the acquisition of Pan International Electronics (Thailand) Co Ltd ("PIE (Thai)") from its holding company at the end of 2005 for a larger geographical footprint. It plans to start CEM activities especially for the automotive sector in Thailand.

Key Points

SWOT ANALYSIS

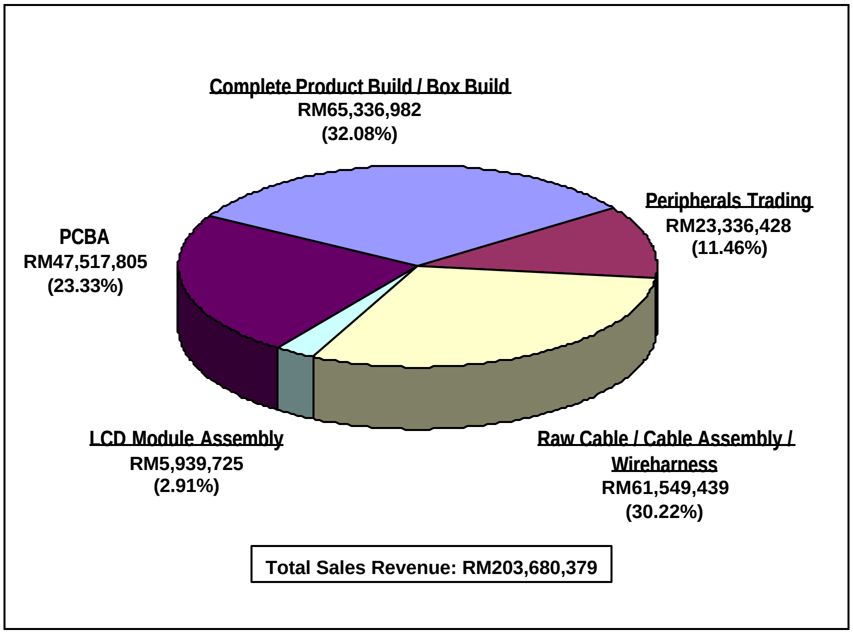
STRENGTHS	WEAKNESSES
• Established track record and close working relationships with multinational consumer and industrial electronic com panies • Strong ultimate holding company in Hon Hai which is the largest EMS company in the world with a turnover and market capitalisation exceeding USD25 billion and USD26 billion respectively. • No requirement for investment in R&D as it relies on the formidable and extensive R&D infrastructure of the Hon Hai group • Access to world class technology and manufacturing processes (through Hon Hai group) which are ahead of its competitors • Leveraging on the group's extensive customer base to expand its own customer base in Malaysia • Economy of scale in Hon Hai group's raw material purchasing which enables more competitive product pricing • Ability to leverage on the group's extensive logistics and distribution network • Its value add is to jointly design and manufacture the components required by its customers • Strong balance sheet. Net cash balance of RM55.2 million (RM0.89 per share)	• Largely reliant on only a few customers • High barrier of entry to other new customers as each customers deals only with very few contractors/suppliers in the consumer and industrial electronics sector • Expectation of cheaper selling price as the product lifespan ages requires PIE to continuously cost down • Continuously secure contracts to manufacture new products/components to maintain margin
OPPORTUNITIES	**THREATS**
• Further expansion into assembling equipment in other sectors like automotive, medical, defence, etc • Expansion into Thailand where several key consumer electronics and automotive companies have set up operations • Targeting other supplier/contractors of its existing customers for sub-assembly components • Market niching into small/medium volume, high mix product manufacturing of high value	• Risk of its customers consolidating which may cannibalised its existing contracts • Dependence on Hon Hai group's R&D resources may results in lack of priority to attend to PIE's requirements as opposed to Hon Hai's requirements • Continuous need to maintain at the forefront of the technology to remain competitive • Strong threat from Chinese manufacturers

Reduce reliance on low margin production of wire harness and cable assembly

Focus on higher margin CEM division to reduce reliance on production of wire harness and cable assembly. Within the CEM division, PIE manufactures various types of products as follows:

- Printed Circuit Board Assembly ("PCBA") for computer, automotive, telecommunication, industrial and consumer electronics
- Flexible Printed Circuits Assembly ("FPCA") for computer, automotive, telecommunication, industrial and consumer electronics
- LCD module assembly
- Mould and die fabrication for precision plastic parts
- Clean room electronic product assembly
- Complete product/box build with prototype and sub-assembly processes

Turnover Segmentation for 2005



Focus on higher margin complete product/box build and small/medium volume, high mix segments

PIE is moving towards higher value added CEM segment of complete product/box build (32% of total FY05 revenue) where it can carve a niche using Hon Hai group's formidable R&D prowess with fewer competitors. In addition, it aims to focus on the small/medium volume, high mix products contracts with high unit value. PIE is able to produce a high mix of products given the flexibility in its assembly plant.

Close to securing another 5 customers for CEM division; no capex increase, just operate two shifts instead of one

PIE's sharp improvement in FY05 financial performance (where net profit grew 51% yoy) was a result of securing 3 new customers, which started placing orders in 2005. PIE had already began courting these customers as far as 2 ½ years ago. It is close to securing another 5 customers, which it has been working on since 2 years ago. This would drive its new phase in revenue growth. PIE does not need to invest further capex to service these customers as it is only operating on one shift and can easily double its capacity by operating another shift.

Diversified customer base reduces seasonal volatility

Its diversified customer base and product range helps reduce seasonal volatilities where shipment/sales of consumer electronics products are usually low in the first quarter of each year.

(1) PSC Ltd (USA)
(2) IO-Data (Japan)
(3) ASP (part of the Philips Group)
(4) Shong King (Taiwan)
(5) Todaiji (Japan)
(6) Lapp Logistics (Germany).

Diversifying within cable and wire harness sector from the traditional computer segment into other industry segment

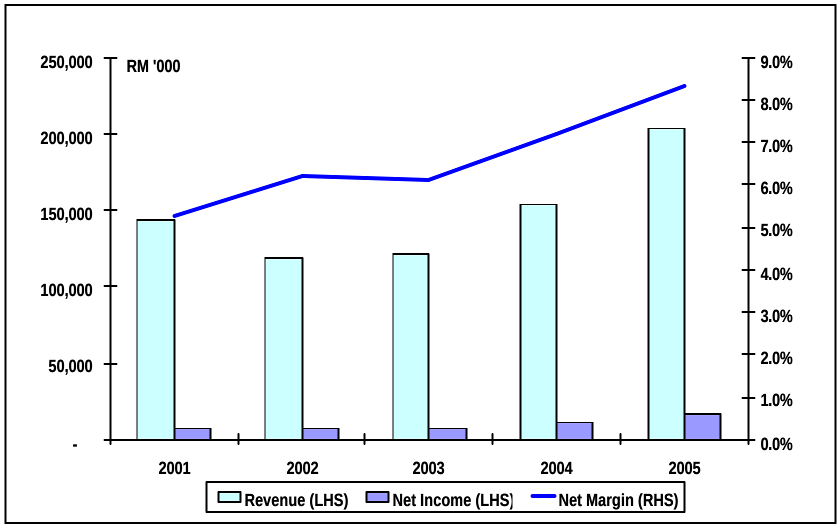
While PIE may have started with computer wire harness and cable assembly (LAN, USB), it has tapped on its capabilities and diversified into telecommunications, industrial and broadband cables (CAT 5 cables) to prevent margin erosion from the more common products where most competitors focus on.

Able to pass on increase in raw material cost of copper and PVC/polymer

The largest raw material component for PIE is copper and PVC/polymers which prices have skyrocketed since the oil prices hike had also resulted in other commodity prices rising equally fast. PIE can pass on the cost increase in raw materials but there will be seasonal time lag from the time sales orders are contracted and when the raw materials are purchased, which prices could have gone up. Nevertheless, over the year the increase in cost averages out.

PIE also engages in trading and distribution of consumer electronic products that the Hon Hai group produces. While they are not famous brands, the quality of the products is the same as world-renown brands that Hon Hai manufactures for. However, trading margin is low at about 2%. Beside diversifying its revenue further, the sale of these products would slowly establish Hon Hai group's own brand.

Continuous Efforts In Product And Customer Diversification Drives Earnings And Margin Improvement



Advantages of being part of the Hon Hai group –the world largest Electronics Manufacturing Services company

Long time supplier/contract of world renown brands like Sony, Apple, Lenova, Dell, HP, Motorola, Nokia and Cisco

Hon Hai which was established in 1974 and listed on the Taiwan Stock Exchange in 1991, is largest EMS company in the world with FY05 turnover and current market capitalisation of USD25 billion and USD26 billion respectively. It assembles for leading brands in 3 different major segments namely PC (Apple, Lenova, Acer, Dell. HP), consumer electronics (Apple–Ipod, Sony) and communications (Sony, Motorola, Nokia and Cisco).

Hon Hai has 3 other public listed entities besides PIE

Not only is Hon Hai listed, it has another 2 associate companies (Pan International Industrial Ltd and Foxconn Technology Ltd) which are listed in Taiwan and another in Hong Kong (Foxconn International Holdings Ltd). Hon Hai could list another two subsidiaries namely, Foxconn Advance Technology (Largest Flexible PCB maker in Taiwan) and Innolux (one of the largest LCD panel manufacturer in Taiwan).

Access to Hon Hai group's R&D capabilities is a distinct advantage over its competitors

PIE benefits from being part of the Hon Hai group in many ways, most importantly, having access to its formidable R&D capabilities. This arrangement reduces PIE's own R&D cost as it will only be charge the R&D services it uses from the group. PIE does not invest in its own R&D. This advantage has enabled PIE to gain at expense of its competitors, who not only have higher cost but also lack behind PIE/Hon Hai group in the technology curve.

Leveraging off Hon Hai's extensive customer base and trackrecord to secure new customers

PIE can leverage off Hon Hai group's existing customer base by bidding for contracts of Hon Hai's customers in this part of the world. In addition, given that PIE's manufacturing processes and practices are the same high standards of the group, it actually open door to bid for new customers.

PIE benefits from Hon Hai's economy of scale in sourcing for raw materials

PIE enjoys cheaper raw material cost given the "group discount" arising from the economy of scale of Hon Hai group's raw material sourcing. This is critical in maintaining margins as the customers would continue to demand for lower prices as the product lifespan ages. In addition to lower prices, PIE also has benefit of global sourcing of raw materials to ensure stable supply at theall times.

Financially sound with net cash of RM0.89 per share

The conservative financial management of the company is reflected in its strong balance sheet. The company remains in a net cash position of RM55.2 million or RM0.89 per share. This gives it ample opportunity to gear up for further expansion and also enabled it to weather through the semiconductor down cycle effortlessly. Its customers being large multinationals are prompt paymasters.

Assumption

We have assumed that the revenue contribution from manufacturing and trading is about 90% and 10% respectively. Taking into consideration of the higher growth, over the next 5 years we have assumed revenue will grow of 29% in FY06 reducing to 14% in FY07 and FY08 and 10% in FY09 and FY10.

Cost escalation on factors of production ranges from 26% in FY06 to 10% in FY10 while capex spending is RM4 million per annum. Dividend payout ratio is 66% of net profit as guided by PIE.

Valuation

PIE is currently trading at 6.1x FY06 P/E multiples compared Hon Hai's 13.8x.. We think PIE deserves to trade at higher valuations. Average EPS growth for the next 3 years is 19%. Given the high growth potential of PIE, we believe our valuation using an 8x PE multiple and FY06E EPS of 41 sen is conservative, translating a valuation of RM3.28 or an upside of 29%. Assuming a dividend payout of 66% of net profit, dividend yield for FY06 (GDPS of 27 sen) could be as high as 10.7%! We are initiating coverage with a **BUY** recommendation.

Earnings Estimates

YE 31 Dec (RM '000)	2004A	2005E	2006E	2007E	2008E
REVENUE	**154,124**	**203,680**	**262,450**	**300,417**	**343,939**
TOTAL OPERATING EXPENSES	**(134,332)**	**(179,441)**	**(226,140)**	**(261,453)**	**(299,474)**
Cost of production	(115,494)	(155,534)	(196,247)	(229,704)	(265,750)
Staff Cost	(13,010)	(16,908)	(18,091)	(19,358)	(20,713)
Other Operating Expenses	(10,467)	(11,240)	(11,802)	(12,392)	(13,012)
Other Operating Income	4,640	4,240	3,937	4,506	5,159
EBITDA	**19,791**	**24,239**	**36,310**	**38,964**	**44,465**
Depreciation & amortisation	(5,422)	(4,458)	(4,558)	(4,759)	(4,960)
OPERATING PROFIT	**14,369**	**19,781**	**31,752**	**34,205**	**39,505**
Interest expense	(171)	(240)	(647)	(679)	(777)
Interest & other income		1,781	1,890	1,908	1,992
Non-operating (charges) /income					
Extraordinary Gain/(Loss)					
Share of result of associated company					
PROFIT BEFORE TAX	**14,198**	**21,322**	**32,994**	**35,434**	**40,720**
Taxation	(3,088)	(4,372)	(7,259)	(7,795)	(8,958)
	22%	21%	22%	22%	22%
NET PROFIT / (LOSS)	**11,111**	**16,950**	**25,736**	**27,638**	**31,762**
Minority Interest					
NET PROFIT ATTRIBUTABLE TO SHAREHOLDERS	**11,111**	**16,950**	**25,736**	**27,638**	**31,762**
	49%	53%	66%	66%	66%
Dividends payable per share	0.12	0.18	0.27	0.29	0.34
Total Dividends	(7,349)	(11,168)	(16,986)	(18,241)	(20,963)
Transfer to Retained Earnings	**3,762**	**5,781**	**8,750**	**9,397**	**10,799**

Source: K&N Kenanga estimates

Balance Sheet

YE 31 Dec (RM '000)	2004A	2005A	2006E	2007E	2008E
Cash & Deposits	67,891	62,997	63,591	66,414	71,613
Amount owing to related companies	586				
Debtors	35,265	47,047	35,952	41,153	47,115
Stocks	22,017	22,903	50,333	57,614	65,961
Other Current Assets	2,016	1,862	3,118	3,689	4,131
CURRENT ASSETS	127,775	134,809	152,993	168,870	188,821
Fixed Assets	82,218	88,854	92,854	96,854	100,854
Depreciation charges	(44,331)	(48,789)	(53,347)	(58,106)	(63,066)
Intangible assets	1,587	3,849			
Investment & others		9,400	9,400	9,400	9,400
TOTAL ASSETS	**167,249**	**188,123**	**201,900**	**217,017**	**236,008**
Short term portion of long term debt					
Revolving Facility / Bankers' acceptances	14,581	7,841	10,786	12,346	14,134
Trade Creditors	9,803	14,558	12,943	14,815	16,961
Taxation	205	997	997	997	997
Other Creditors	4,591	8,761	12,215	14,502	18,723
Amount owing to related companies	274	213	456	457	494
CURRENT LIABILITIES	29,454	32,370	37,397	43,117	51,309
Long Term Debts					
Other Long -Term Liabilities	3,689	5,598	5,598	5,598	5,598
TOTAL LIABILITIES	**33,143**	**37,968**	**42,995**	**48,715**	**56,907**
Share Capital	61,239	62,046	62,046	62,046	62,046
Retained Earnings	87,426	97,237	105,987	115,384	126,183
Other Reserves	(14,558)	(9,128)	(9,128)	(9,128)	(9,128)
TOTAL EQUITY	**134,106**	**150,155**	**158,905**	**168,302**	**179,101**
Minority interests					
TOTAL LIABILITIES & EQUITY	**167,249**	**188,123**	**201,900**	**217,017**	**236,008**

Source: K&N Kenanga estimates

Cash Flow Estimates

(RM '000m)	2004A	2005A	2006E	2007E	2008E
EBITDA	19,791	24,239	36,310	38,964	44,465
Change in Net Working Capital	(16,478)	(3,589)	(15,752)	(8,894)	(8,384)
Taxation	(3,088)	(4,372)	(7,259)	(7,795)	(8,958)
Interest Income	739	1,781	1,890	1,908	1,992
Interest Expense	(171)	(240)	(647)	(679)	(777)
Other non-cash income/expenses	(1,254)				
CASH FLOW FROM OPERATIONS	**(460)**	**17,819**	**14,542**	**23,503**	**28,337**
Net Capital Expenditure	(1,070)	(6,636)	(4,000)	(4,000)	(4,000)
Change in Other Assets / Liabilities	18,009	(8,436)	4,092	1	37
CASH FLOW FROM INVESTMENT	**16,939**	**(15,072)**	**92**	**(3,999)**	**(3,963)**
FREE CASH FLOW	**16,479**	**2,747**	**14,635**	**19,504**	**24,374**
Net Drawdown /(Repayment) of Borrowings	9,165	(6,740)	2,945	1,560	1,789
Dividends paid	(7,349)	(11,168)	(16,986)	(18,241)	(20,963)
Others					
Share Issuance	2,133	10,267			
CASH FLOW FROM FINANCING	**3,949**	**(7,641)**	**(14,041)**	**(16,681)**	**(19,174)**
NET CASH FLOW	**20,427**	**(4,894)**	**594**	**2,823**	**5,200**
OPENING CASH AND BANK DEPOSITS	47,463	67,891	62,997	63,590	66,413
ENDING CASH AND BANK DEPOSITS	**67,891**	**62,997**	**63,590**	**66,413**	**71,613**
ENDING CASH BALANCE AS PER BALANCE SHEET	**67,891**	**62,997**	**63,591**	**66,414**	**71,613**
EBITDA	19,791	24,239	36,310	38,964	44,465
Change in Net Working Capital	(16,478)	(3,589)	(15,752)	(8,894)	(8,384)

Source: K&N Kenanga estimates

Published and printed by:
K & N KENANGA BHD (15678-H)
801, 8th Floor, Kenanga International, Jalan Sultan Ismail, 50250 Kuala Lumpur, Malaysia
Telephone: (603) 2166 6822 Facsimile: (603) 2166 6823 (603) 2713 2292
Website: www.kenangaresearch.com

Head of Malaysia Research