

Corporate Highlights



RHB Research Institute Sdn Bhd
A member of the RHB Banking Group
Company No: 233327 -M

Sector Update

7 May 2010

Timber

Recom : **Neutral**
(Maintained)

Highlights From Timber Conference

Table 1 : Timber Sector Valuations

FYE	Price (RM/s)	Fair Value (RM/s)	EPS (sen)		EPS growth (%)		PER (x)		P/NTA (x)	P/CF (x)	GDY (%)	Rec	
			FY10	FY11	FY10	FY11	FY10	FY11	FY10	FY10	FY10		
Ta Ann	Dec	5.27	7.60	54.1	66.6	90.0	23.0	9.7	7.9	6.6	1.5	1.3	OP
Evergreen	Dec	1.45	2.35	21.3	23.3	26.1	9.4	6.8	6.2	6.1	1.0	3.4	OP
WTKH	Dec	1.22	1.55	11.1	15.0	+>100.0	34.7	11.0	8.1	6.4	0.7	4.9	OP
Jaya Tiasa^	Apr	3.45	3.05	27.7	55.5	+>100.0	+>100.0	12.5	6.2	9.2	0.9	0.0	UP
Sector Avg					101.7	37.5	9.6	7.0					

^ FY10-11 valuations refer to those of FY11-FY12

- ◆ We hosted a Timber and Furniture Day last week, where we invited management from Samling Global /Lingui Development and WTK Holdings to speak on the outlook of the sector and their company's prospects.
- ◆ **Low inventory in Japan shoring up selling prices in near term.** While both Lingui and WTK have seen timber product prices trending upward on a gradual basis since early-2010, this increase has largely been driven by restocking activities in Japan rather than actual demand growth coming from higher construction activity. Management from both companies were basically in agreement that there is a risk that the Japan market could remain weak in the near term, unless construction activities start picking up more aggressively.
- ◆ **Medium to longer term risk relatively limited?** However, in the medium to longer term, given that Japan's housing starts are at such a low level already, management of both companies believe the downside risk in sales volumes would be relatively limited, especially in view of the recovering global economy.
- ◆ **Cost of production on an increasing trend.** Both timber producers agreed that cost of production is on a rising trend, mainly due to higher logging costs, caused by higher fuel, labour and machinery costs. However, this problem can be countered by rising economies of scale, in an improving timber market environment, given the high fixed costs involved, which provide timber companies with high operational leverage.
- ◆ **Risks.** 1) Timber demand improving significantly, resulting in higher-than-expected timber prices; 2) A sharper-than-expected recovery in Japan's economy; 3) Reduced competition from other major plywood exporting countries (i.e. Indonesia and China) due to plant closure etc.; and 4) Significant reductions in glue and logistics costs.
- ◆ **Valuations.** We reiterate our **Outperform** recommendation on WTK as we believe that it is one of the key beneficiaries of a recovery in plywood prices. Maintain our fair value of WTK at RM1.55 based on unchanged 14x CY10 EPS. We also derive Lingui's fair value based on 14x CY10 consensus EPS, which implies a fair value of RM0.80. However, we note that consensus numbers may not have factored in the potential upside from the rising plywood prices. We also believe that there could be a possibility of privatisation by Samling Global which could generate further interest in the stock. All in, we maintain our **Neutral** recommendation on the sector.

Chart 1. Japan Total Log Imports

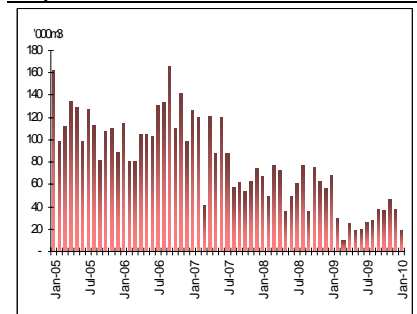
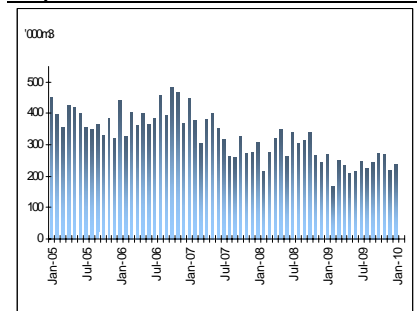


Chart 2 Japan Total Plywood Imports

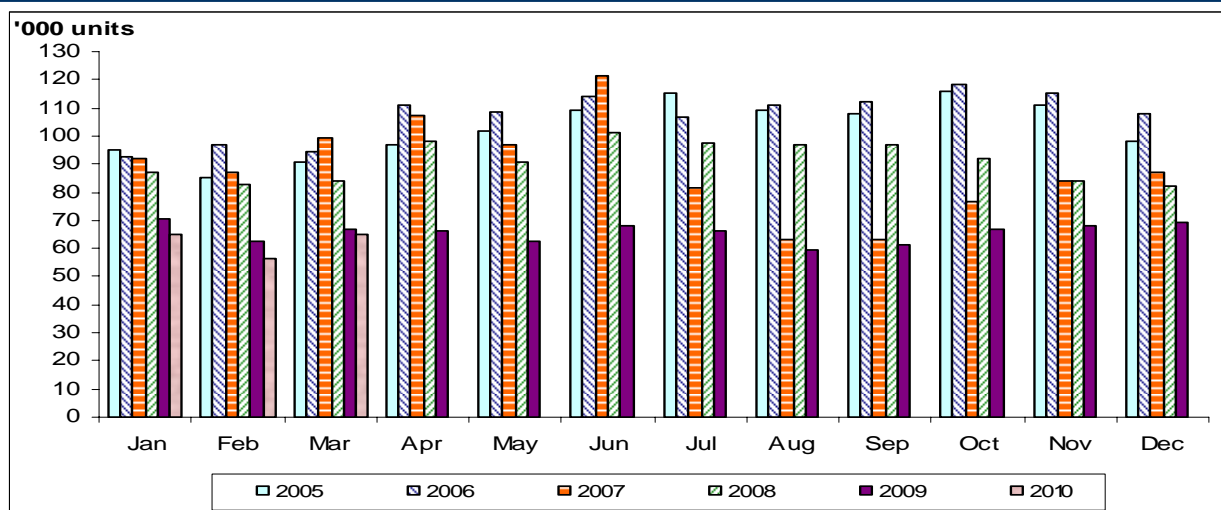


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- ◆ **Key highlights.** We hosted a Timber and Furniture Day last week, where we invited management from Samling Global Limited/Lingui Development and WTK Holdings to speak on the outlook of the sector and their company's prospects. The key highlights were: 1) low inventory in Japan is expected to shore up plywood selling prices in near term; 2) medium- to longer-term risk is relatively limited given the low base; and 3) cost of production is on a rising trend offset by higher capacity utilisation.
- ◆ **Low inventory in Japan shoring up selling prices in near term.** While both Lingui and WTK have seen timber product prices trending upward on a gradual basis since the beginning of the year, this increase has largely been driven by restocking activities in Japan rather than actual demand growth coming from higher construction activity. We understand stock levels in Japan are currently very low (almost at "Just-In Time" levels) due to the supply constraints caused by domestic plywood manufacturers cutting back production previously. Management from both companies were basically in agreement that there is a risk that the Japan market could remain weak in the near term, unless construction activities start picking up in a more aggressive manner. We note that Japan's housing starts recorded a 16th straight month of decline in Mar 2010, dropping 2.4% yoy to 65,008 units while the value of construction orders received by the big 50 contractors increased by 42.3% yoy in Mar 2010, reversing an earlier decline of 20.3% in Feb 2010. If the signs of a reversal are to continue, we could potentially see signs of construction activities picking up.

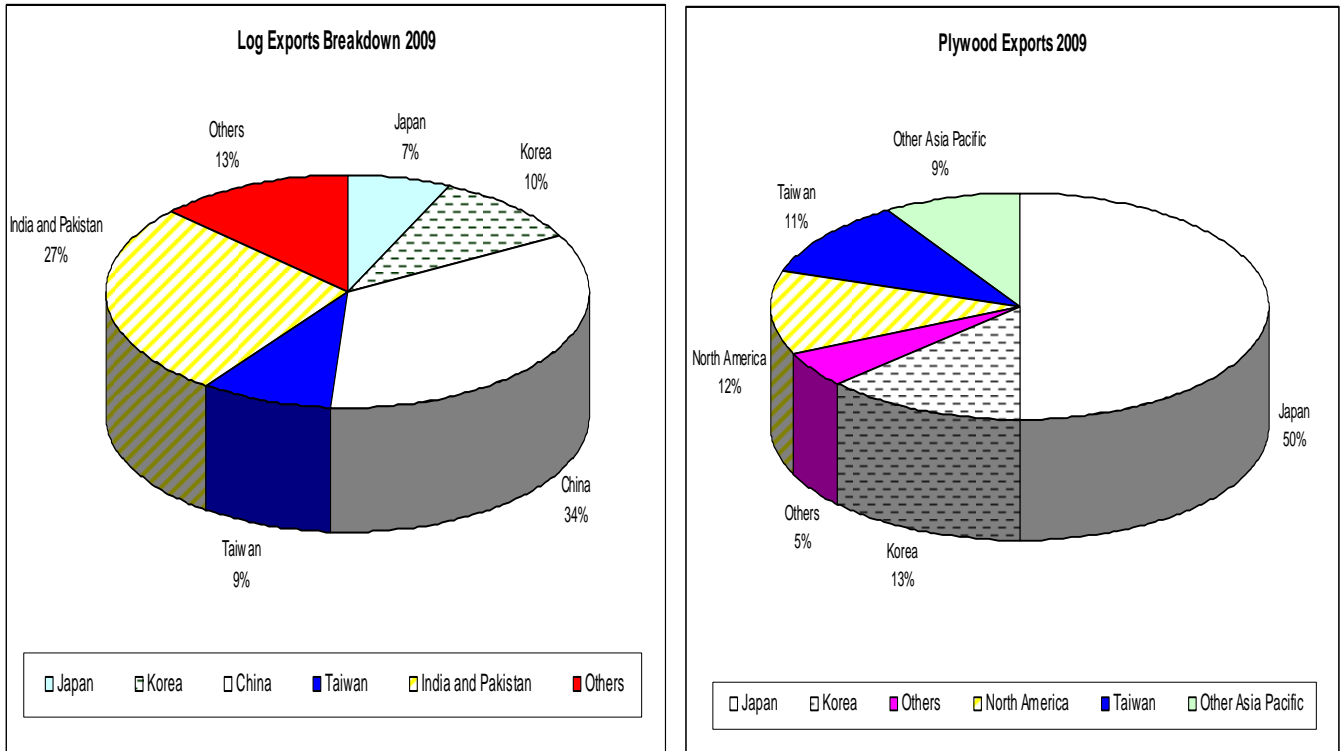
Chart 3: Monthly Japan Housing Starts



Source: Japan Lumber Report, RHBRI

- ◆ **Medium- to longer-term risk relatively limited?** However, in the medium to longer term, given that Japan's housing starts are at such a low level already, management of both companies believe the downside risk of sales volumes would be relatively limited, especially in view of a recovering global economy. We believe Japan will continue to be the price setter for Malaysian plywood products, given that it is still the largest importer of Malaysian plywood products currently, with Malaysian products comprising 53% of Japan's plywood imports.
- ◆ **Lingui shifting market focus for plywood away from Japan to other countries.** Although Japan still makes up the bulk of both Lingui and WTK's export revenue, we believe both companies have found ways to supplement their revenue, in the event of weak demand from Japan. In Lingui's case, management indicated that it has shifted its focus to other countries where demand is strong, namely Korea, US, Taiwan and the Middle East, amongst others. Management estimates that its log exports to Japan made up less than 10% of total log exports in 2009 (versus 20-30% previously), while for plywood, exports to Japan made up about 50% of total plywood exports in 2009 (versus 55-60% previously), and this has reduced further to 30-35% in 2010. We understand the main markets that took over from Japan were Korea and the US, which in 2009, already contributed 13% and 12% to Lingui's plywood exports, respectively (see Chart 4).

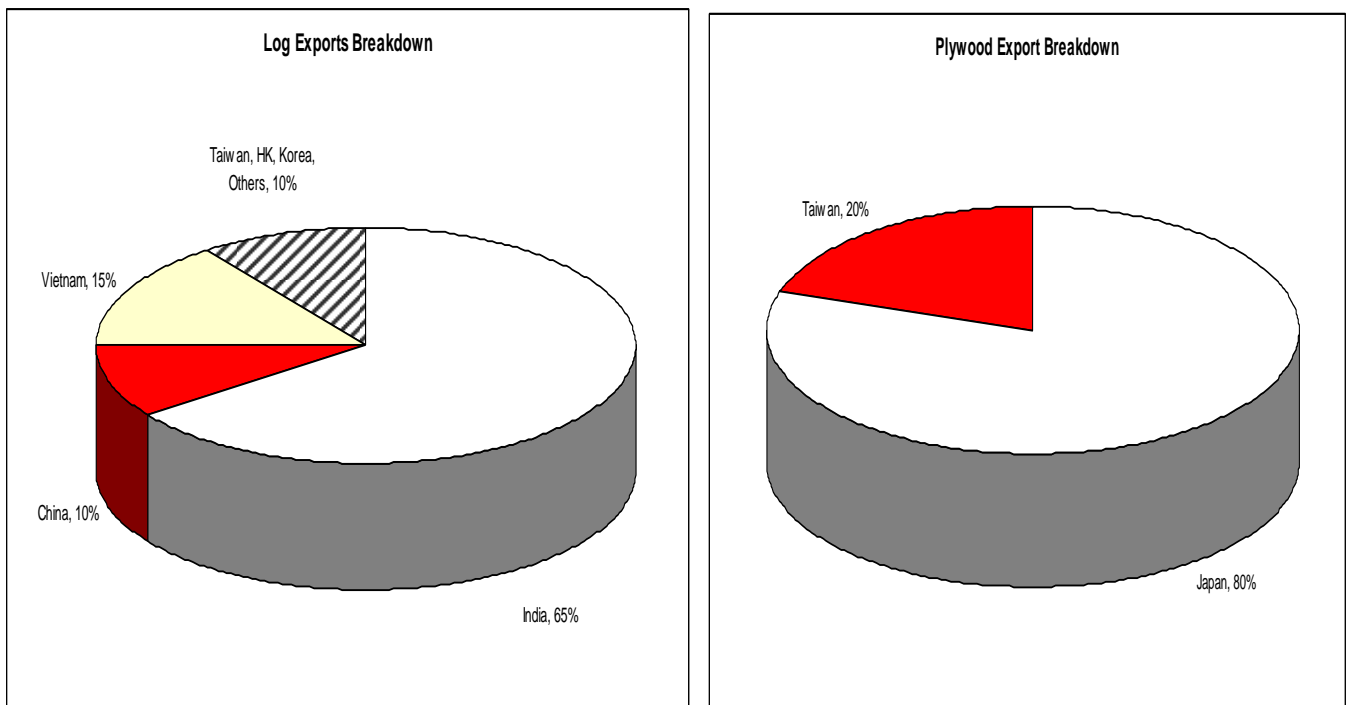
Chart 4. Lingui's 2009 Geographical Revenue Breakdown



Source: Company

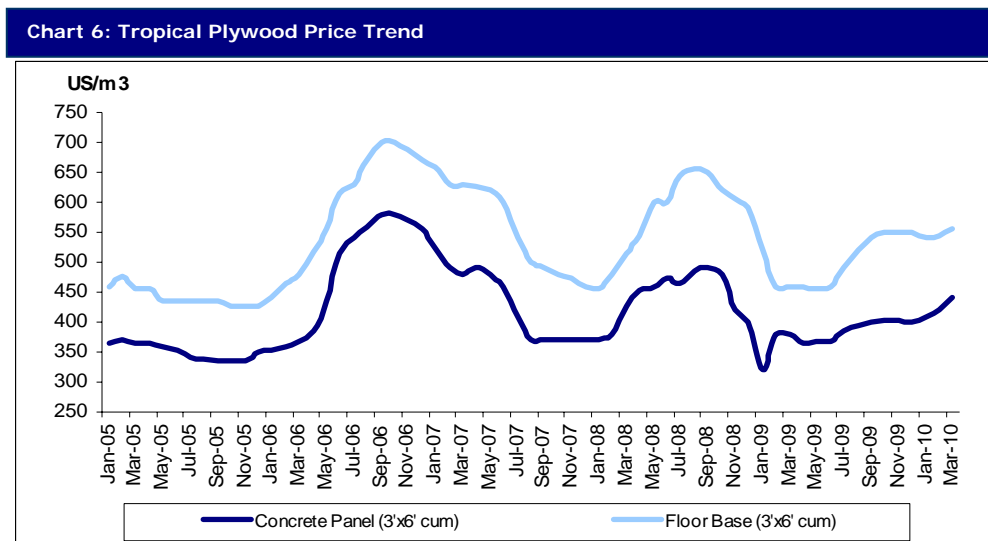
- ◆ **No need to shift export markets for WTK, due to high-end products.** For WTK, management indicated that there has not really been a need to shift its focus to other export markets, given that the bulk (60%) of its exports to Japan are for higher-end floor-based products, where demand is relatively stable. Plywood exports to Japan continue to contribute 80% to sales, while WTK does not really export logs to Japan. WTK's main export market for logs is India, which contributes 65% (see Chart 5).

Chart 5. WTK's Geographical Revenue Breakdown



Source: Company

- ◆ **Any risk with shift of focus to Korea?** We highlight that there could be a risk, however, with Lingui's shift of focus to countries like Korea, given the recent accusation made by the Korean Trade Commission (KTC) that eight plywood exporters from Sarawak and one from Peninsular Malaysia were dumping their products in South Korea, at selling prices that were about 88% below the local market price. Although the Sarawak Timber Association (STA) and Sarawak Timber Industry Development Corp (STIDC) have jointly refuted these accusations, if there is no proof that the allegations are incorrect, the possible consequence is that South Korea would ban imports of Malaysian plywood. While this would definitely be negative for Malaysian plywood producers, we believe there could potentially be a misconception that the dumped plywood products are coming from Malaysia, as we understand from the latest ITTO report that exports from Indonesia to South Korea had more than doubled in the first two months of 2010, which could indicate that the dumped products are from Indonesia. In addition, Lingui's management has not seen any reduction in exports to Korea of late and believes that the dumping could potentially be from smallholders, and not the "big boys" of timber.
- ◆ **Rising selling price trend expected to continue.** We note that Lingui has experienced a 10% YTD rise in selling prices for its plywood products up to Apr 2010 (to US\$440-445/cum from US\$400/cum beginning of the year), while May/Jun 2010 indicative prices are up by another 4-6% to US\$465/cum from Apr 2010. Given the strong price trend, management expects plywood prices to rise by yet another US\$10-15/cum by year-end to approximately US\$480/cum, which would translate to a 20% price increase on a yoy basis. As for WTK, it has also seen an 8-17% YTD increase in selling prices for its plywood products since Jan 2010, and expects to see the gradual rising trend of prices continue into 2HCY2010. As for logs, both companies expect log prices to remain relatively stable in the medium term, as it has been for the last 3-6 months. In our WTK forecasts, we have only assumed an increase in plywood prices of 10-14% yoy in CY10. We are thus revising our assumption upwards to reflect a larger increase of 18-20% yoy for CY10 instead while maintaining our CY11-12 price increase assumption at 2-5% yoy. We have also adjusted our US\$ against MYR assumptions to RM3.25/US\$ in CY10 (from RM3.30/US\$), RM3.20/US\$ in CY11 (from RM3.25/US\$) and RM3.15/US\$ in CY12 (from RM3.30/US\$), following RHBRI economic team's revised forecasts. As for plywood volumes, we have already projected an increase in production volumes of 25% yoy for FY10, which assumes WTK is operating at 75% capacity utilisation rate, which is in line with its current utilisation rate. Going forward, we have assumed WTK's capacity utilisation rising to 80% and 85% in FY11-12.



Source: Japan Lumber Report, RHBRI

- ◆ **Cost of production on our increasing trend.** Both timber producers agreed that cost of production is on a rising trend, mainly due to higher logging costs, caused by higher fuel, labour and machinery costs. The timber industry is also facing the same labour issues as the plantation industry in terms of shortage of Indonesian workers and this will continue to be an issue in the medium to long term. Labour costs currently comprise 10-15% of total production costs. However, management of both companies believe that this problem can be countered by rising economies of scale, in an improving timber market environment, given the high fixed costs involved, which provide timber companies with high operational leverage. We understand Lingui's plywood

production costs are at approximately US\$420-430/cum currently, while log costs are about US\$130/cum. For WTK, we understand plywood costs (for its floor-based plywood) are about US\$500/cum currently, while log costs are about US\$100/cum. WTK's plywood costs are in line with our expectations while log costs are slightly lower than our full-year expectations of US\$105/cum in CY10. Despite this, we prefer to maintain our cost assumption for CY10 to be conservative. We have assumed plywood costs to drop by 3% yoy in CY11 following higher utilisation capacity and to remain flattish in CY12 as further cost savings from higher utilisation capacity would be offset by the rising costs.

Growth Drivers

- ◆ **WTK's growth drivers...** WTK has put in place some strategies to ensure sustainable long-term growth going forward, including:
 - 1) Continue to increase its focus on higher-margin products – by raising its floor-based plywood product contribution to 65-70% (from 60% currently) of total plywood sales;
 - 2) To resume planting of palm oil estate at a rate of 3,500ha per year; and
 - 3) To continue planting of its forest plantation at a rate of 3,000ha per year.
- ◆ While strategies 1) and 3) are in line with our forecasts, the planting rate of 3,500ha per year of palm oil land is higher than our assumption of 2,000ha per year. As such, we have increased our planting rate to be in line with management's guidance. We have also now included earnings contributions from the plantation division starting from FY11 onwards with the following assumptions: 1) mature hectarage of 3,000ha and 5,000ha; 2) FFB yield assumption of 6t/ha and 9t/ha; 3) FFB price assumptions of RM600/t and RM570/t; and 4) FFB cost p/t of RM340 and RM330; for FY11-12 respectively. The inclusion of the plantation division earnings has added 5% and 11% to our forecasts for WTK for FY11-12 respectively.
- ◆ **Lingui, largest in Malaysia.** Lingui Developments is an integrated forest resource and wood product company involved in extraction, manufacturing and sale of timber logs and plywood products. Most of Lingui's revenue composition currently comes from sale of logs and basic plywood products, with a small portion coming from specialty products like door facings and housing products. Its products are exported to over 30 countries with China, India and Japan accounting for over 50% of log sales and plywood/veneer sales. In Malaysia, Lingui has a forest concession of 1.33m ha and a forest plantation of 458,000ha. In New Zealand, Lingui has a 35,000ha forest plantation of softwood trees. In terms of production capacity, Lingui has 950,000cum capacity for plywood, 100,000 cum for MDF and 54,900 cum capacity for sawntimber. Lingui's substantial shareholder is HK-listed Samling Global Limited (Not Rated), which owns 67.2% of Lingui.
- ◆ **... and Lingui's growth drivers.** As for Lingui, the company also has several strategies aimed at growing profitability in a sustainable manner, including:
 - 1) Shift of focus to other countries like US, China and India, which are poised to see strong growth and recovery in demand;
 - 2) Increase production of value-added products and increase access to international markets;
 - 3) Construct a plywood/veneer mill in New Zealand for distribution domestically and to Australia and Japan;
 - 4) Cross selling of the group's products to sell New Zealand logs to emerging markets like India and China;
 - 5) Tight monitoring of cash cost of production and cost control in each business; and
 - 6) Continue to increase forest plantation area at an average rate of 9,000ha/year.

Chart 7: Lingui's Product Structure



Source: Company Annual Report

Risks

- ◆ **Main risks include:** 1) Timber demand improving significantly, resulting in higher-than-expected timber prices; 2) A sharper-than-expected recovery in Japan's economy; 3) Reduced competition from other major plywood exporting countries (i.e. Indonesia and China) due to plant closure etc.; and 4) Significant reductions in glue and logistics costs.

Forecasts

- ◆ **Tweaked earnings forecasts for WTK** by 0.6%, 2.6% and -8.8% in FY10-12 after making the following changes: 1) updating our US\$/MYR assumptions to RM3.25/US\$ in CY10 (from RM3.30/US\$), RM3.20/US\$ in CY11 (from RM3.25/US\$) and RM3.15/US\$ in CY12 (from RM3.30/US\$); 2) increasing our yoy increase in plywood prices assumptions to 18-20% yoy in CY10 (from 10-14%); 3) included plantation division earnings into our earnings forecasts; and 4) updated our FY09 assumptions.

Valuation and recommendation

- ◆ **Maintain Outperform recommendation on WTK.** We believe WTK is one of the key beneficiaries of a recovery in plywood prices and given the low base, we expect earnings growth to be substantial over the next few years. As such, we reiterate our **Outperform** recommendation on the stock. We maintain our fair value of WTK at RM1.55 based on unchanged 14x CY10 EPS. We also note that WTK's share price is about 45% correlated with plywood prices.
- ◆ **Lingui fairly valued for now, but with potential upside.** Based on target PER of 14x CY10 (average target PE of timber sector) against consensus earnings, we derive a fair value of RM0.80. Although this is actually below current market price of Lingui, we note that consensus numbers may not have factored in the potential upside from the rising plywood price environment.
- ◆ **Possibility of privatisation?** We also believe that there is possibility that Samling Global may privatise Lingui given its high 67.2% shareholding level currently, which could potentially generate further interest in the stock. Recall that back in Apr 06, Samling Global announced that it triggered a mandatory general offer (MGO) for Lingui shares, after its shareholding rose to 40.75% (from 39.87% previously) and subsequently, an acceptance of only 19.82% of shares was received. There was no option to extend the offer period. After the failed MGO, Samling maintained its stake at relatively the same level for several years before upping it to 67.2% in 2QCY09, buying shares from one of Lingui's ex-shareholder, Sojitz Corp, Japan. We therefore believe the recent increase in shareholding may be another attempt to privatise the company at a later stage. As current price levels, Samling would need RM270.4m to privatise Lingui, which Samling may not have problem funding, given its net debt level

of 0.1x as at Jun 09, capex requirement of US\$40-50m p.a. and operating cashflow of US\$70-100m p.a.. We believe the likelihood of a privatisation of Lingui would increase as prospects for the timber industry improve further, which we expect to come through from 2011 onwards.

Table 2: Timber Players

	Forest concession (ha)	Plywood / veneer capacity (cum)	Market capitalisation (RM)
Ta Ann	383,067	330,000	1,116.1
WTK	387,777	330,000	534.4
Jaya Tiasa	712,463	774,000	1,003.0
Lingui	764,000	950,000	831.1

Souce: Company, Bloomberg

Chart 8: TaAnn Technical View Point



- ◆ TaAnn was trapped within a range of RM4.18 to RM4.81 from Jul 2009 to Feb 2010.
- ◆ But in Feb, the stock's upward momentum improved and its price was pushed to a high of RM6.10, near a chart resistance of RM6.05.
- ◆ However, the rally was halted by a stream of profit-taking activities. As a result, the stock was pressed to below RM6.05 and subsequently fell below the 10-day and 40-day SMAs near RM5.67 and RM5.70.
- ◆ The stock fell another 5.2% on Thursday, losing 29sen to RM5.27, with a huge bearish candle recorded on the chart.
- ◆ Given the downbeat momentum readings on the indicators, plus the marginal cut of the 10-day SMA to below the 40-day SMA that has indicating a potential medium-term bearish turn ahead, the stock is poised to fall further.
- ◆ On follow-through selling momentum, it could reach the lower support range of RM4.18 to RM4.81 soon.

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Outperform = The stock return is expected to exceed the FBM KLCI benchmark by greater than five percentage points over the next 6-12 months.

Trading Buy = Short-term positive development on the stock that could lead to a re-rating in the share price and translate into an absolute return of 15% or more over a period of three months, but fundamentals are not strong enough to warrant an Outperform call. It is generally for investors who are willing to take on higher risks.

Market Perform = The stock return is expected to be in line with the FBM KLCI benchmark (+/- five percentage points) over the next 6-12 months.

Underperform = The stock return is expected to underperform the FBM KLCI benchmark by more than five percentage points over the next 6-12 months.

Industry/Sector Ratings

Overweight = Industry expected to outperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Neutral = Industry expected to perform in line with the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Underweight = Industry expected to underperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

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