Fund managers turn defensive

Discussion moderated by C.S. TAN and assisted by YEOW POOI LING

StarBiz Roundtable Discussion on the Stock Market - Part 1

StarBiz Roundtable Discussion on the Stock Market - Part 2

StarBiz Roundtable Discussion on the Stock Market - Part 3

StarBiz Roundtable Discussion on the Stock Market - Part 4

StarBiz Roundtable Discussion on the Stock Market - Part 5

StarBiz Roundtable Discussion on the Stock Market - Part 6

StarBiz Roundtable Discussion on the Stock Market - Part 7

StarBiz Roundtable Discussion on the Stock Market - Part 8

StarBiz Roundtable Discussion on the Stock Market - Part 9

Oil-based revenue, directly and indirectly, is financing about 45% of the government budget today.

Five fund managers and heads of research shared their views on the stock market and favourite stocks at a roundtable discussion at Menara Star. The participants were Aseambankers Equity Research head Vincent Khoo, icapital.biz Bhd head Tan Teng Boo, Meridian Asset Management chief investment officer Tan Beng Ling, CIMB-Principal Asset Management chief investment officer Raymond Tang and TA Securities Holdings Bhd head of research Kaladher Govindan.

StarBiz: There has been some renewed interest in stocks other than plantations. Do you expect this interest in certain sectors or stocks to continue?


Tan Beng Ling

Stock picks:
- S.P. Setia
- IJM
- Tan Chong Motor
- CBIP
- Muhibbah

"When the MNCs come to Malaysia and find the factories full of Indonesians, they say, why do they need to come to Malaysia?."


Tan Teng Boo

Stock picks:
- Padini
- PIE
- Tong Herr
- Parkson
- TM International

"If car prices were 40% to 50% lower, we can afford a 20% to 30% increase in petrol prices."


Raymond Tang

Stock picks:
- Parkson
- Lion Industries
- Resorts World
- Ramunia
- Dialog

"Foreign fund managers were surprised and pleased the handover of state governments was made with no unrest on the streets."

Khoo: Obviously, the risk appetite has improved since March but we remain cautious of external headwinds. The US faces stagflation, with oil prices hitting new highs. This heightens worries that at some point, global economies are going to be weakened substantially.

Are the funds overweight somewhere else or underweight everywhere?

Khoo: If you look at the share price performance of regional equities, there have been quite good recovery in badly hit markets such as Singapore. The funds are probably still overweight in the big markets.

The world could live with a US$100 oil price. Do you think the markets will take it gently at this level of US$125 or, if Goldman Sachs has

it right, that it may go to US$150 and above?

Beng Ling: If you look at the numbers that are coming out, you may see the scenario of stagflation. Like Vincent, I'm a bit wary of the external front as well. In Malaysia, we have to admit that, unlike half a year ago, we have the political baggage that we are carrying, which perhaps explains why our market did not rebound as much as regionally.

Looking back with hindsight from the political tsunami, certain stocks came back quite well and it was a good buying opportunity.

Beng Ling: There were stocks that were dragged down in panic. These were not politically-linked stocks but with proven management and good balance sheet. These are the stocks that rebounded faster. But there are stocks that are more dependent on policy changes, for example, construction. Of course, construction stocks were also hit because of the rising prices of building materials. So it has become a very thematic market but overall market breadth is not quite there.

Do you agree with Beng Ling that political uncertainties are holding investors back from the market?

Tang: Yes I agree. It is not a change in government yet but a loss in a super majority. It's quite a milestone in Malaysian politics. Unlike the Philippines and Thailand, which are used to changing governments, we are not. Therefore, investors look at us and say we don't have experience or they've no memory of such a change compared to Thailand. When the Thai coup happened, it was business as usual. I would expect as time goes on, foreigners will form that kind of opinion of us too.

Foreign fund managers told us they were surprised and pleased that the handover of state governments was made with no problems or unrest on the streets. It showed the political maturity of both parties that they accepted the change although they might have not liked it.

The market requires political analysis now, not just economic analysis. But back to economic issues – do you think inflation will reduce consumer spending?

Beng Ling: Consumption spending will inevitably be affected at some point in time. With oil prices surging and increase in food prices, inflation is going to be a problem. And if I look at the latest export numbers, I'm quite concerned – a drop of over 20% in electronics exports.

Manufacturing exports have been weaker for Malaysia compared with other regional countries. To what extent is this a failure of the private sector and what is the role of the Government in this?

Kaladher: You have to consider what are the structural problems. Our education system is one of the main grouses of foreign investors. We do not have the talent pool of workers required to move up the value chain. Our broadband infrastructure, which is a key element for transactions, operates at a much slower speed than in other countries. Information is key and when you can't transfer information fast, it partly affects the whole system.

Beng Ling: If you talked to some of the MNCs, they will tell you this – when they come to Malaysia and find the factories full of Indonesian workers, why do they need to come to Malaysia?

Tang: We should move up the value-added curve in commodities. Why don't we build the refineries here and export the final products instead of selling our oil and buying crude oil from Saudi Arabia to refine? If we continue to play the price arbitrage, it is just financial gains. The growth in the GDP is not distributed down to the lower level. It is only captured on the top fragment.

Crude oil is a major component of the GDP which does not reach the man on the street?

Tang: It is reaching the man on the street via a subsidy but subsidies do not put money into their pocket. A subsidy reduces the amount you spend but people would rather have money in their pockets than have cheaper goods.

They also want subsidies that take less from their pockets, such as petrol and electricity.

Tang: They are already subsidised and yet we're still not competitive. It means there are a lot of moving parts in the equation which are not efficient. It could be labour, taxes, shareholding structure or policy. These are components that need to work together and not just relying on cheap electricity and petrol.

Beng Ling: When you talk about electricity being subsidised, there are Tenaga Nasional, IPPs (independent power producers) and consumers. Where does the subsidy go? That is a policy thing.

Tang: If you want to reduce subsidy, reduce the subsidy for manufacturers. Yes, manufacturing is 30% of the economy but where is the added value to the economy? Are we continuing to subsidise so that they can hop along for a few more years?

The man on the street feels that petrol should continue to be subsidised. Do you think we can manage that with our oil export revenue or is it fine in the short-term but could cause problems in the long run?

Khoo: Financially, the Government can afford it. Oil-based revenue, directly and indirectly, is financing about 45% of the government budget today. Petronas can probably be called in to cough out more to support the consumer. The other question is – will it encourage a subsidy mentality and discourage innovation and productivity?

Are there other comments on the petrol subsidy?

Kaladher: If they want to cut the subsidies, the same rule should be applied elsewhere in the supply chain. On the one hand you want to cut the subsidy, on the other hand, you should be doing something about car prices.

Teng Boo: If car prices were 40% to 50% lower than what they are now, a lot of us can afford the extra 20% to 30% increase in petrol prices. So it's not just petrol price per se. It is because there is no efficiency thrust across the entire economy. If you're able to achieve that, you can free up a lot of other subsidies and we can still afford petrol prices at RM3 a litre.

Sales taxes on cars are also a subsidy for the Government since it is a major component of tax revenue now.

Teng Boo: That's a static situation. If you have a very efficient economy, FDIs (foreign direct investments) are going to come in and you will receive revenue from different sources. Singapore and Hong Kong are growing at 7% and both economies are having budget surpluses. Why are we having higher taxes and we're still running at budget deficit of 3%?

What are the stock picks of your choice?

Khoo: Our picks are based on a short-term horizon without looking for "multi-baggers" against the stagflation scenario. For the meantime, there are stocks that the market may be interested in – these companies are benefiting from strong earnings momentum.

They are Public Bank, UMW Holdings, Ann Joo, Hap Seng Consolidated and Alam Maritim. The large-cap companies are fairly valued in most cases. The deep value is in mid- and small-cap stocks. But we're still defensive and we want to have a good mix.

Public Bank is more for safety, being the bank with the largest market cap. We like it for its good sustainable yields. **UMW** is a twin play of oil and gas and auto. Auto is one of the sectors besides steel that we like a lot because it is going to beat consensus forecasts by a wide margin. UMW is trading at 10 times forward earnings. There is a lot of room for upside since historically, the company traded at 13 times. Based on our earnings forecast, we're 15% ahead of consensus and even with that, we've only assumed that auto earnings will be up 10% to 15%.

We like **Ann Joo** because we believe the second quarter will again surprise on the upside. The first quarter had already surprised, partly because of its low inventory costs. Beyond that, this company, which is trading at a single-digit PE, offers a good transformation story. It's the first steel company to adopt a mini blast furnace in Malaysia and this brings a structural change to the company, in its ability to lower cost and produce more value added items such as flat products.

Hap Seng Consolidated Bhd is also trading at single-digit PE. It's more of an opportunistic buy call because it is trading at deep discount to its break-up value, which runs to RM5 a share. It's a resource play, benefiting from the rise in palm oil prices. It owns 51% of Hap Seng Plantations Bhd. There is also a big run in the prices of fertilisers. Hap Seng is one of the key distributors of fertilisers in Malaysia and Indonesia. This division will see a 10-fold increase in earnings year-on-year from a modest base.

The oil and gas theme will rage on. **Alam Maritim** is one of those companies growing at least 30%. It is growing also because it has an interesting leaseback strategy which allows it to finance off balance sheet. It is looking into two new areas. The first is fleet ownership which provides 20% returns on a five-year payback period. Secondly it is bidding for an underwater maintenance contract. We believe these initiatives would bear fruit.

Teng Boo: Padini is still strong in our buy list. Local consumption growth is still strong and we like it because of its strong balance sheet. They used to rely on the *Vincci* brand but now the *Padini* brand has overtaken it. It will give them a better source of growth in the coming years.

The next one, **PIE**, was on our 2006 list when I was last at a roundtable here. PIE's share price has gone up 80% to 90% since. It has a strong balance sheet. Its prospects are still attractive to us.

Tong Herr came down to our buying range. It's another Taiwanese company with a strong balance sheet. Valuations for these three companies are attractive.

Parkson went up a lot but has dropped to a price where valuation is attractive again. The exposure is basically China. This is one of the purest retail plays for exposure to Asian consumer spending. Yet Parkson, listed on Bursa Malaysia, is trading at a hefty discount to Parkson in Hong Kong, which only has Parkson China. Parkson in Malaysia has exposure to Vietnam where, in less than two years, it has four to five outlets that are profitable. We find this kind of divergences pretty attractive.

Our last pick is **TM International.** If you look at mobile phone companies generally, the valuation of TMI seems to be on the low side.

PIE has done surprisingly well in the electronics sector.

Teng Boo: Its cable harnessing is also doing well because of strong global demand. Their major businesses have done well, not just the electronics side.

How comfortable are you that Parkson will stay focused on what it's doing since Lion tends to be diversified?

Teng Boo: If you look at the entire group, they realised strategies in the past were not yielding the results desired. I can't imagine Parkson Retail in Hong Kong or in Malaysia changing their names, or going into construction or computer assembly. They can go into other business but the massacre will be cruel. I don't think that's going to happen. Parkson Holding Bhd will stay focused on retail and it is still expanding in Malaysia, Vietnam and China. Their capital expenditure in China is huge.

Beng Ling: I'm looking at stocks that have done worse than the KLCI, which have fallen 15% from the top this year. **SP Setia's** share price has weakened by some 30%. You're buying into the management, brand name and at this stage, they are moving out of the Klang Valley to Penang and Vietnam. This is probably the top property group to buy in Malaysia.

For the construction sector, I like **IJM Corp Bhd,** which has been bashed down. I don't have to elaborate on the strong management team. They have a proven track record in Malaysia and overseas. It has property undergoing restructuring and there is a capital repayment following the completion of the exercise. It also has exposure in plantations. The share price has come off some 30% this year.

I like **Tan Chong Motor,** which is trading at 7 to 8 times PE. They have two very successful models that are set to double its earnings this year. More importantly, there is a change in the Nissan relationship with Tan Chong, which will sustain its long terms earnings prospects.

My next choice is **CBIP** which makes palm oil mills. With so many plantations setting up, there will be demand for palm oil mills. CBIP is trading at 7 times PE. Whether the palm oil price goes up further or not is not an issue for this company. **Muhibbah Engineering's** share price has corrected a bit. The company has proven itself locally and overseas. The group has heavy exposure in the oil and gas sector.

There seems to be some differing views on SP Setia among analysts.

Beng Ling: You have to take a longer view on both SP Setia and IJM, and not expect them to recover in three to six months. They have proven management and it's a good time to gain exposure.

Is SP Setia's Vietnam story conceptual at this stage?

Beng Ling: It's interesting that SP Setia was nowhere 10 years ago. It has come a long way. With the same management, I'm confident that they have a good chance of delivery.

How has Tan Chong's relationship changed with Nissan?

Beng Ling: They took a bold move to build a plant in Serendah, which cemented the relationship with Nissan. There are plans to launch three new models every year. The two newly launched models have a waiting list of six months.

There seems to be concerns over steel input costs for CBIP.

Beng Ling: That is a valid concern but they could pass on the steel costs. The share price has also corrected so much. Typically, plantation stocks are valued to 15 times PE. This proxy is trading at 7 times to 8 times.

Tang: It will be a difficult market this year. We focus on earnings sustainability of companies and transformation of certain firms. One of my picks is the same as Teng Boo's, which is **Parkson** so I shall not elaborate more on it. Its expansion in China would go beyond the coastal cities. It's looking at second and third tier cities with 15 million to 20 million population. In five years' time, these cities will become first and second tier cities.

The second tier cities will probably take 10 to 15 years to become first tier while third tier cities will take about the same duration to move up to second. You have a long-term sustainable model to move your stores to future markets. It is also buying out a lot of minority shareholders and at cheap valuations. It's enhancing valuation immediately. It also has revenue sharing in its retail concessions. It is not a normal model where you rent out the shelf space.

Lion Industries Bhd is traded cheaper against its peers because of shareholder risk – it is trading below 5 times PE. We don't expect it to be rated to the same valuation as its peers, but even going to 7 times, there is a 40% upside potential.

Resorts World Bhd has divested its stake in Star Cruises. It generates cash flow of about RM500mil every year and with that kind of cashflow, it is self-repairing for any balance sheet. Within a year or two, Resorts will be back with a big war chest. They can easily raise a couple more billion to make acquisitions. I don't think the much-rumoured privatisation is going to happen because it is too costly.

Ramunia is undergoing a major exercise to be taken over by a subsidiary of MISC. When the exercise is completed, MISC will be the biggest shareholder and it will channel a lot of work from its yard to Ramunia. That's a transformational play.

Dialog is a unique oil and gas play. The company is in project financing and looking at sustainable earnings. They have a share in the projects they build. This is one of the few oil and gas companies that is totally un-geared but with cash.

How long do you think this steel cycle will last?

Tang: It took over a year for investors to latch on to the CPO theme. There were a lot of sceptics in 2005. There was a mental block in the market when the price crossed RM1,500 and people thought it wasn't sustainable but it went on to RM3,500. In steel, there has been a lot of under-investment in plants. The market wants high-grade cold roll and high-grade hot roll. It does not want the long rolls for construction anymore. They want all these to make cars and so on. The market has shifted to more quality and not quantity.

There were concerns that Ramunia's Indian contract bid was too low.

Tang: That is one of the concerns but we're looking at the transformation story, which entails the shift of projects to Ramunia from MMHE, the subsidiary of MISC. That will overshadow the Indian contract. If the Indian contract doesn't flow through, it doesn't affect the transformation.

Kaladher: Our stock picks are defensive but we're still bullish on the oil and gas sector. There are about 20 PSCs (production sharing contracts) and 16 new discoveries. Petronas is likely to pump up its capex to RM30bil by 2010 or 2011. Those that are asset heavy, like **SapuraCrest**, will benefit a lot.

Another stock in the oil and gas sector is Dayang Enterprise. Its profit margins are the best among listed entities at around 25%. This is because they are enjoying economies of scale and their specialty vessels are new. Its 15 months forecast in its IPO was about RM45mil and if you annualised that, it will be around RM35mil. The last six-month performance showed profits of about RM20mil at core level. I believe the company can easily do RM60mil this year and that translates to about 8 times PE.

I'm still bullish over plantation play. I have **KL Kepong** on my list because it is the cheapest among the three big-cap plantation stocks under our coverage. It is trading at 12 times PE. KLK has a good palm age profile with about 34% at prime age and another 35% of young palms. It is the only plantation player with exposure to rubber prices. Some 13% of its planted areas are rubber trees.

Tanjong plc is defensive in nature with 85% profit contribution from the power sector. Investment in Globeleq is turning around strongly. This year, we're expecting RM109mil of profit for this financial year. Dividend yield is about 6.5% and EPS is expected to grow about 20% this year. It has RM1bil cash in its balance sheet and the company is looking for merger and acquisition opportunities in South Africa or Asia this year.

LCL Corp is benefiting from the oil boom in the Middle East. It has a RM1.3bil order book and its exposure in India is also huge.