

MALAYSIAN AE MODELS HLDG.

DIRT CHEAP!

BUY

INVESTMENT HIGHLIGHTS

- **Earnings and 12-month target price upgrades.** The 9mFY07 net earnings of Malaysian AE Models Holdings ("MAEMODE") came in above our earlier expectations. Outstanding order book currently stands at about RM260.5m, and MAEMODE is bidding for RM700m worth of jobs with an expected 35% success rate. We are raising our FY07 and FY08 net earnings forecasts by 10.2% and 7.8% to RM19.3m and RM25.7m, respectively. Maintain BUY with a revised 12-month target price of RM2.10 (+10.5% from RM1.90 previously) based on a FY08 P/E (fully diluted) of 10.0x.
- **Key Earnings Drivers:** (1) Stronger-than-expected revenue growth, especially to China and Indonesia; (2) Operating profit margins recovery on the back of greater focus on the higher margins businesses (Automated Handling System, Sorting & Retrieving System and Bulk Materials Handling System) and higher capacity utilization rate; (3) Lower financing cost; and (4) Lower group effective tax rate.
- **High borrowings manageable.** Net gearing of 97.2% as at 28 Feb 07 was rather high but well covered by the expected FY07 net interest cover of 4.1x, which we expect to improve to 4.6x in FY08. Moreover, most of the trade debtors involve multinational companies ("MNCs") with low default risks. The actual bad debts written off were no more than RM80,000 in each of the past three years as MAEMODE has been highly selective on both customers and projects.
- **Compelling valuations, re-rating anticipated.** The shares are trading at a fully diluted FY07 and FY08 P/E of 8.5x and 6.5x, respectively, with a 2-year (FY06-FY08) PEG ratio of just 0.23x. High gearing, which we believe is manageable, is needed to fund revenue and earnings growth due to MAEMODE's under-capitalization.

Price	RM1.35
Target Price	RM2.10-
52-weeks High/Low	RM0.86-RM1.45
Issued Shares	95.1m
Market Capitalisation	RM128.4m
Board	Main
Sector	Industrial
BMCI	1363.40
Syariah-compliant	Yes
Stock Code	Xxxx
Bloomberg	xxxx MK



Major Shareholders (> 5%)

Aemic Corp (M) S/B	32.29%
Atlantis Asian Recovery Fund	7.89%
Estimated Free Float	Approx. 59.82%

Analyst

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Per Share Data

Y/E: 31 May	2005	2006	2007E	2008F
Book Value (RM)	1.47	1.59	1.78	2.05
Cash Flow (sen)	23.1	22.9	31.3	38.6
Earnings (sen)	12.9	12.5	20.3	27.0
Gross Dividend (sen)	0.5	0.5	0.5	0.5
Net Payout Ratio	2.8	2.9	1.8	1.3
P/E (x)	10.5	10.8	6.7	5.0
P/E (x) (Diluted)	0.0	13.5	8.5	6.5
P/CF	5.8	5.9	4.3	3.5
P/Book Value	0.9	0.9	0.8	0.7
Gross Div. Yield (%)	0.4	0.4	0.4	0.4
ROE (%)	7.7	8.3	12.2	14.3
Net Gearing (%)	72.5	91.9	92.9	78.6


P&L Analysis

Y/E: 31 May (RMm)	2005	2006	2007E	2008F
Revenue	186.0	286.8	349.5	402.6
EBITDA	28.2	37.5	47.6	57.9
Depreciation	7.1	9.8	10.5	11.0
Interest Expense	9.8	9.9	12.6	14.3
Pre-tax Profit	12.6	18.6	25.7	34.3
Effective tax rate (%)	26.6	35.1	24.0	24.0
Net Profit	9.0	11.9	19.3	25.7
Operating Margin (%)	11.8	9.9	10.9	12.0
Pre-tax Margin (%)	6.8	6.5	7.4	8.5
Net Margin (%)	4.8	4.1	5.5	6.4

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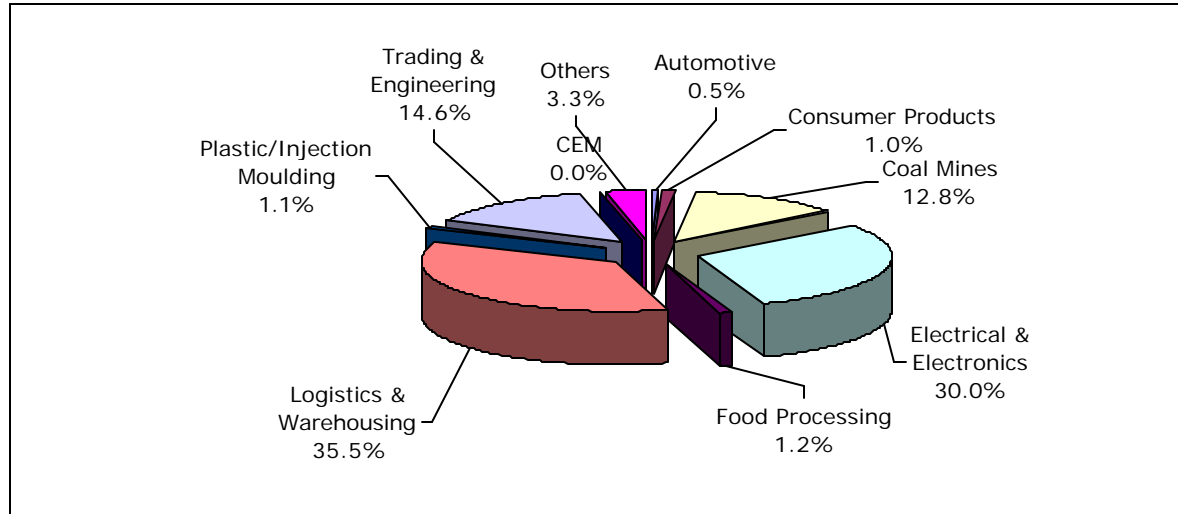
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Background

Since our BUY-recommendation on 22 March 2006, the share price of MAEMODE has appreciated by 52.5% and outperformed the BMCI by 4.8%. While our earlier RM1.90-target price has yet to be reached, better-than-expected earnings outlook, which we believe is sustainable, has prompted us to raise our 12-month target price by 10.5% to RM2.10/share.

To recap, MAEMODE group is principally involved in the provision of one-stop automated materials handling and factory automation system solutions. Over the past few years, MAEMODE has successfully reduced its dependence on the electrical and electronic (“E&E”) sector, which used to account for 55% of the group’s FY01 revenue, by pumping up sales to the logistics, warehousing and coal industries.

FIGURE 1: 1HFY07 REVENUE BREAKDOWN BY INDUSTRY SEGMENT

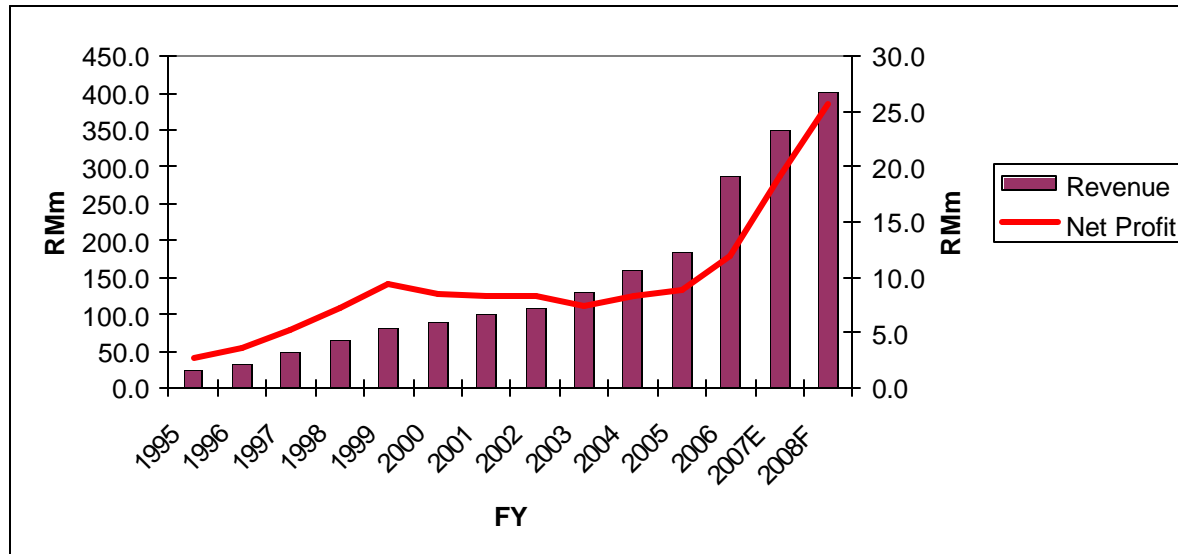


Source: MAEMODE

As a strategy, MAEMODE focuses mainly on the medium-end product/technology segment, as the low-end segment is highly price competitive. MAEMODE also works closely with international industry leaders on the large scale and high-end projects by working as their sub-contractor. A few international players such as Siemens Automation & Drives of Germany, FKI Logistex of United Kingdom, Swisslog of Switzerland and Okura Corporation of Japan dominate the high-end product segment.

The strategy has worked well judging from rising profitability since FY03 (See Figure 2). The average project size handled has increased to RM3m/project in FY06 vis-à-vis RM0.75m/project 4 years ago. The largest single project undertaken to-date was the RM32.2m-Reflow Oven project in FY06.

FIGURE 2: TRACK RECORD AND EXPECTED FUTURE PERFORMANCE



Despite rising profitability, MAEMODE shares continue to trade at rather low FY07 and FY08 P/E of 8.5x and 6.5x, respectively, presumably because of its high gearing and “perceived” weak cash flow position.

ANATOMY OF MAEMODE’S GEARING AND CASH FLOW

Leading international industry players are using their balance sheet to secure BIG projects through provision of vendor financing. Being a medium-end player and often a sub-contractor to these international industry leaders, MAEMODE has no choice but to be more flexible in terms of accommodating project-based progress payments.

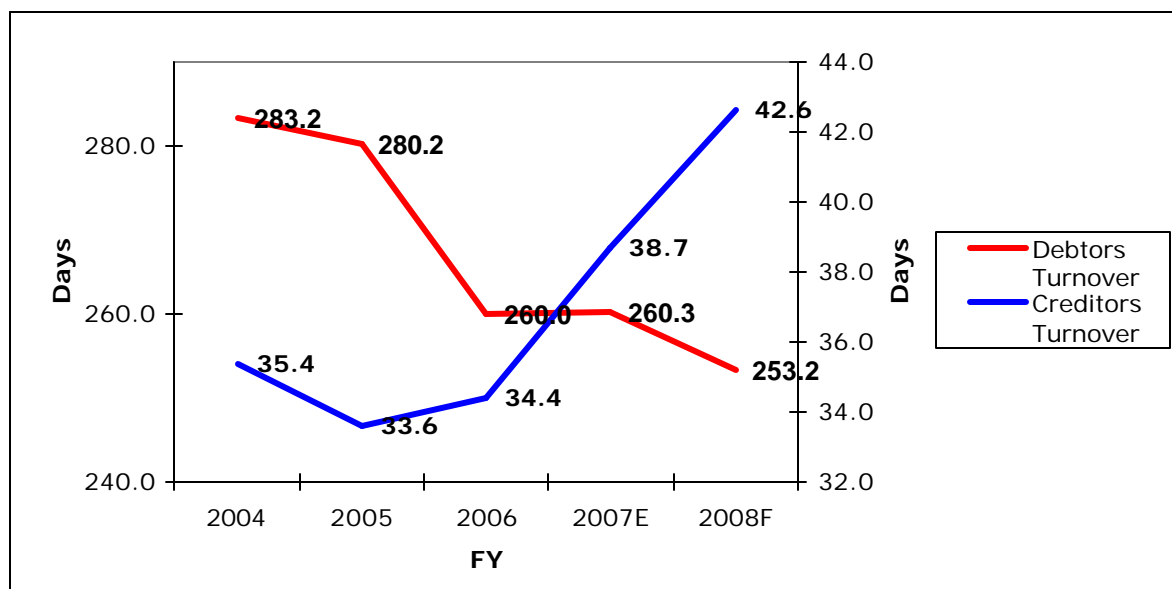
MAEMODE’s rising project-based revenue and profit in recent years have resulted in rising trade debtors, which have to be funded by borrowings, as the company is rather under-capitalized (Shareholders’ funds of RM150.9m as at end-FY06) when compared with its business volume (FY06 revenue of RM286.8m).

In FY06, MAEMODE’s project-based revenue grew 89.9% y-y (vis-à-vis group revenue growth of 54.2% y-y) and accounted for 25.9% of group revenue. As at end-FY06, the project-related trade debtors grew 35.2% y-y (vis-à-vis group trade debtors growth of 29.0% y-y) and accounted for 34.9% of group trade debtors. What most people do not realize is that the project-based trade debtors are essentially contract works-in-progress (“WIP”). Classifying that differently would have resulted in less alarming trade debtors.

To mitigate default risks, MAEMODE has been highly selective on the customers it deals with and the projects undertaken. It is also not dependant on any single customer as its top 5 customers currently contribute only about 24% of group revenue. While credit period granted to customers is relatively long, actual bad debts written off in each of the past 3 years had never exceeded RM80,000 (0.027% of FY06 revenue).

While FY06’s Debtors Turnover ratio of 260.0 days was rather high on an absolute basis, it did show steady improvements when compared with FY05’s 280.2days and FY04’s 283.2days, and we expect further improvements in FY07 and FY08.

FIGURE 3: DEBTORS & CREDITORS TURNOVER



Source: Annual reports and Kenanga’s estimates

To better explain the impact of a typical project on MAEMODE’s revenue, profit, trade debtors and operating cash flow, lets walk through a *hypothetical* RM10m-project.

As illustrated in Table 1, 60% of a typical project’s revenue is usually received in the form of progress payments up to the point of project completion (Point A). Another 30-35% of the project’s revenue is usually received only at the point of commissioning of the system implemented (Point B), which is normally 3-month after point A. The balanced 5-10% retention sum is usually received only at point of warranty expiration (Point C), which is usually 12-month after point B.

MAEMODE offers 10%-retention sum only in return for future maintenance and servicing contract, which usually amount to 7% of project value. Maintenance and servicing contracts offer better profit margins, shorter credit period (30-90 days) and are recurrent in nature (currently worth RM110m annually).

MAEMODE usually takes 6-9 months to complete a smaller project (typically < RM10m). A project that is worth RM10m and above could take as long as 18months to complete (or reach Point A).

TABLE 1: REVENUE, PROFIT AND CASH FLOW CYCLES - ILLUSTRATION

	RMm
Project size	10.0
Point A: Point of project completion	
Revenue recognized	10.0
Operating profit recognized *	1.0
<i>* Assuming 10% operating margins</i>	
Cash - Progress payment received	+6.0
Trade Debtors #	+4.0
<i># Funded by borrowings</i>	
Point B: Point of commissioning	
Revenue recognized	0.0
Operating profit recognized	0.0
Cash - Outstanding payment received	+3.0 to 3.5
Trade Debtors	-(-3.0 to 3.5)
Point C: Point of warranty expiration	
Cash – Retention sum received	0.5 to 1.0
Trade Debtors	-(0.5 to 1.0)

TABLE 2: DEBTORS AND CREDITORS AGEING REPORT @ 28 FEB 2007

Days	Debtors (%)	Creditors (%)
0-60	19%	51%
61-120	31%	15%
121-180	33%	13%
181-365	18%	18%
>365	2%	3%
Provision for doubtful debts	-3%	0%
Total	100%	100%

The irony about MAEMODE's cash flow position is that it will improve one-year into a business slow down assuming no significant deterioration in the level of bad debt!

EARNINGS OUTLOOK – MOMENTUM INTACT

Outstanding order book (Malaysia: 31.2%, China: 18.0%; Indonesia: 15.3%; and Hong Kong: 10.7%) currently stands at about RM260.5m, and MAEMODE is in the midst of tendering for some RM700m worth of contracts of which RM300m are in China and Indonesia.

We are raising our FY07 and FY08 net profit forecasts by 10.2% and 7.8% to RM19.3m and RM25.7m, respectively, on the back of stronger-than-expected demand for logistics and warehousing systems from China and bulk handling systems from Indonesia, which translate into better-than-expected revenue growth.

The profit margins recovery, aided by better product mix, lower financing cost and effective tax rate, is in line with our expectations.

VALUATIONS & RECOMMENDATIONS

We maintain our BUY-rating on MAEMODE with a revised 12-month target price of RM2.10 (+10.5% from RM1.90 previously), which is based on a FY08 P/E (fully diluted) of 10.0x.

At RM1.35/share, the stock is trading at a 2-year (FY06-FY08) PEG ratio of just 0.23x, and a FY07 and FY08 P/E of 8.5x and 6.5x, respectively.