STANDARD & POOR'S

EP Manufacturing

Recommendation: **STRONG BUY**

Stock Code: 7773 | Bloomberg: EPMB MK | Price: MYR0.44 | 12-Month Target Price: MYR0.60 | Date: March 24, 2008

Board: Main

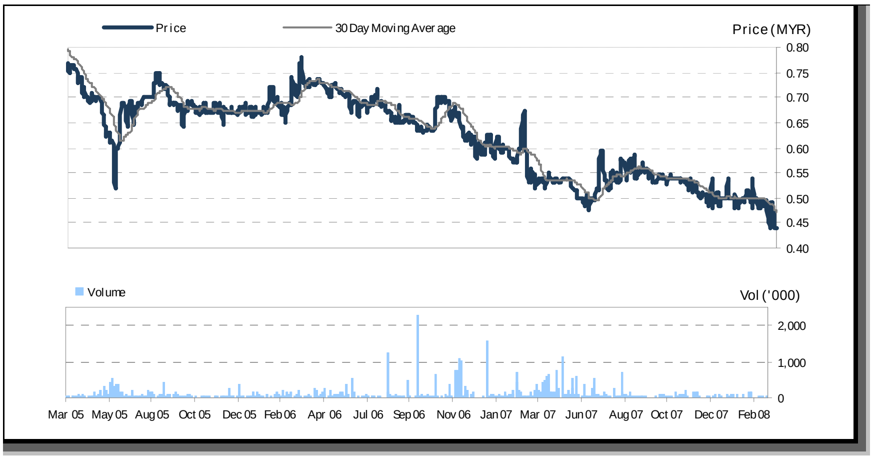
Sector: Industrial Products

GICS: Consumer Discretionary/Auto Parts & Equipment

Market Value - Total: MYR54.8 mln

Summary: Main-board listed EP Manufacturing is a Tier-1 autoparts vendor to both Proton and Perodua. It also supplies to Toyota in the Middle East. Through its technical collaboration with Bosch, the group focuses on the supply of higher value modular components. In late 2007, EPMB diversified into the electronic water meter business.

Analyst: Alexander Chia, ACA



Highlights

- EP Manufacturing Bhd (EPMB) supplies various parts to most models sold by both Proton and Perodua. It also supplies to Toyota in the Middle East.
- Profitability was affected in the last two years due to lower sales and production volumes at Proton. However, EPMB's outlook is set to improve this year with the recovery of the local automotive industry, and in particular, the robust bookings for Proton's latest models.
- EPMB's latest high value component, Intake Air Fuel Module (IAFM), which enhances engine performance, is fitted in the Saga and Persona models, generating significant new revenue for EPMB.
- In Oct. 2007, the group also diversified into the manufacture of electronic water meters. The meter has been proven to reduce non-revenue water levels. Sales are targeted for both domestic and overseas markets.
- We project 2008 revenue and net profit to reach MYR357.8 mln (+18% YoY) and MYR13.9 mln (vs. a loss of MYR0.5 mln in 2007) respectively, driven by higher sales by Proton and Perodua, as well as new revenue streams from IAFM and water meters.

Investment Risks

- Risks to our recommendation and target price include production interruptions at Proton which would delay deliveries, changes in the regulatory policies which may adversely affect EPMB, and fluctuation in raw materials pricing.

Recommendation

- We initiate coverage on EPMB with a Strong Buy recommendation, and a 12-month target price of 60 sen.
- Our target price includes a projected 1.5 sen tax-exempt dividend, which will give a healthy net dividend yield of 3.4%. We expect management to resume its dividend payment this year after a halt in 2006 and 2007.
- We derive our target price by ascribing a PER of 7x to EPMB's forecast 2008 fully diluted EPS of 8.3 sen. We believe the group's lackluster performance in 2007 is in the price with EPMB currently trading at an attractive forward PER of 5x.
- EPMB's outlook appears to be improving after turning around and recording profits in 2H07 compared to a net loss of MYR6.4 mln for 1H07. We note that several competitors remained loss-making in 4Q07.
- EPMB's earnings catalysts include: i) improved sales at Proton driven by new Saga and Persona, ii) increased sales to Perodua, iii) new contribution from IAFM, a high value high margin item which is fitted into every Saga and Persona, and iv) maiden contribution from its water meter business venture.

Key Stock Statistics

FY Dec.	2007	2008E
Reported EPS (sen)	-0.2	8.3
PER (x)	NM	5.3
Dividend/Share (sen)	0.0	1.5
NTA/Share (MYR)	0.44	0.43
Book Value/Share (MYR)	1.60	1.30
No. of Outstanding Shares (mln)	124.4	
52-week Share Price Range (MYR)	0.44 - 0.60	
Major Shareholders:	%	
Mutual Concept Sdn. Bhd.	21.9	
Hamidon bin Abdullah	7.0	

* This is a Syariah-compliant stock

Per Share Data

FY Dec.	2005	2006	2007	2008E
Book Value (MYR)	1.68	1.63	1.60	1.30
Cash Flow (sen)	22.6	11.5	11.8	21.8
Reported Earnings (sen)	12.3	1.2	-0.2	8.3
Dividend (sen)	6.0	0.0	0.0	1.5
Payout Ratio (%)	46.5	0.0	0.0	18.0
PER (x)	3.6	37.0	NM	5.3
P/Cash Flow (x)	1.9	3.8	3.7	2.0
P/Book Value (x)	0.3	0.3	0.3	0.3
Dividend Yield (%)	13.6	0.0	0.0	3.4
ROE (%)	NA	1.4	-0.3	6.7
Net Gearing (%)	67.3	119.1	124.9	116.0

All required disclosures and analyst certification appear on the last two pages of this report. Additional information is available upon request.

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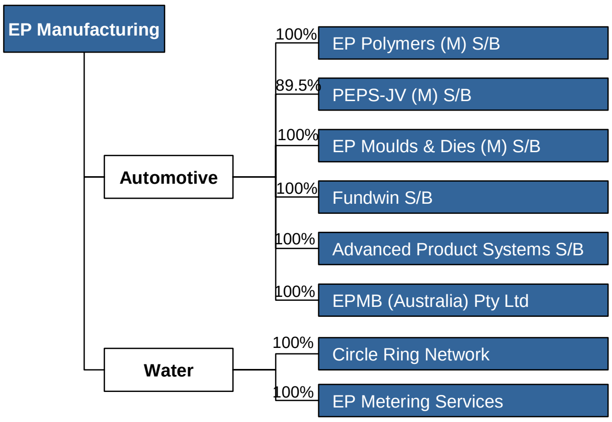
Background

Corporate Profile

Incorporated in 1996, EP Manufacturing Bhd (EPMB) and its subsidiaries are principally involved in the manufacture and supply of automotive components. EPMB was first listed on the Second Board of Bursa Malaysia Securities in Mar. 1997 before it was transferred to the Main Board in Sep. 2004. In late 2007, the group diversified into the manufacture of electronic water meters through the acquisition of the entire interest in Circle Ring Network Sdn Bhd (CRN).

At the helm of EPMB is founder and Executive Chairman, En. Hamidon Abdullah who has a 7.0%-direct stake in the company. The other major shareholder in EPMB is Mutual Concept Sdn. Bhd. (21.9%) in which En. Hamidon is also a shareholder.

Corporate Structure



Source: Company data

Business

Post acquisition of CRN last year, the group now has two core manufacturing businesses – automotive components and electronic water meters.

Automotive Components

Since its humble beginnings in 1982, the group has since evolved into a Tier-1 vendor to both national carmakers, Proton Holdings Bhd (PROH MK, MYR3.96, Not Ranked) and Perusahaan Otomobil Kedua Sdn Bhd (Perodua). As a Tier-1 vendor, EPMB supplies directly to Proton and Perodua in sizeable volume and hence, enabling economies of scale.

EPMB supplies modular assemblies, suspension parts, body and engine parts and engineering plastic parts and lamp assemblies. Some of the group's key products include Intake Air Fuel Module (IAFM), front and back corner modules (braking systems), fuel tank module, parking brake, fuel rail, duplex assembly, cross member, garnish hood, side turn signal, front bumper, front and rear lamp, grille and side mirror.

EPMB's key customers and car models using its products:

Proton	:	Saga, Persona, Gen-2, Savvy, Neo, Waja, Wira, Iswara
Perodua	:	Viva, Myvi, Kenari, Kelisa, Kancil (being phased out)
Toyota*	:	Land Cruiser, Camry, Corolla, Hilux, Prado, Yaris, Terios

** only for models sold in the Middle East*

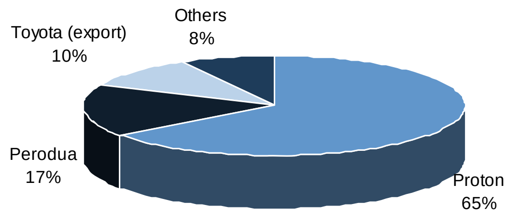
The group has two manufacturing facilities – one in Shah Alam (built-up of 160,000 sq ft) and the other in Batang Kali (built-up of 428,000 sq ft). Its metal stamping line in the Batang Kali plant is the largest amongst the automotive components suppliers in Malaysia. EPMB also operates a R&D team in Australia focusing on components design and parts for the Middle Eastern market.

To ensure it remains a forerunner in automotive technology, EPMB has forged strategic partnerships with Robert Bosch (Australia) Pty Ltd (Bosch) and Koito Manufacturing Co Ltd (Koito) since 2003 and 1994 respectively. The automotive technology division under the Bosch worldwide group recorded revenue of EUR27.2 bln in 2006 and is the leading supplier of automotive components to many original equipment manufacturers (OEM). Meanwhile, Koito is one of the world's largest automotive lamp manufacturers. In May 2007, Koito had a major success with the commercialization the world's first LED headlamp.

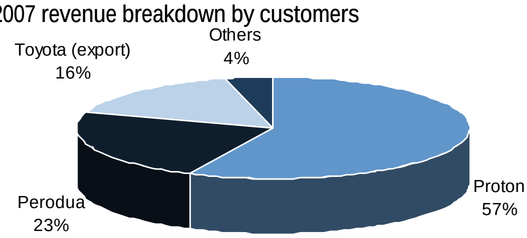
The strategic collaborations have been very beneficial to EPMB. Through its joint effort with Bosch, EPMB has successfully developed the corner module system (braking system) which is used in all Gen-2 and Persona models. And more recently, EPMB scored another success with its IAFM product. Leveraging on technical know-how of Bosch, the IAFM is an engineered plastic technology driven module which replaces the current single-runner aluminium air intake manifold. It works in tandem with the engine management system to control and vary the air intake, ensuring optimum air-fuel mixture to the engine combustion chamber. This results in better acceleration at low engine speed, allowing better overtaking performance and improved fuel consumption. IAFM is currently fitted into the Persona and the new Saga models.

Proton is EPMB's largest customer, contributing 65% of its revenue in 2006. However, this fell to 57% in 2007 as EPMB's supply to Perodua increased. Revenue contribution from Perodua surged to 23% in 2007 vs. 17% previously, largely due higher component value supplied by EPMB, especially for the Viva model. At the same time, the group's export of Toyota components to the Middle East is also picking up pace, with sales making up one sixth of the group revenue in 2007 (vs. 10% in 2006).

2006 revenue breakdown by customers



2007 revenue breakdown by customers



Source: Company data

On the cost side, raw materials are mainly steel and steel-based components as well as resin. We believe raw materials constitute between 60% and 70% of total revenue. We understand the raw materials are mostly sourced via local agents and are transacted in MYR.

In terms of competitors, EPMB faces competition from other automotive component suppliers in the country, who also supply to the national carmakers. Amongst the listed companies are Ingress Corporation Bhd (INGC MK, MYR0.51, Not Ranked), APM Automotive Holdings Bhd (APM MK, MYR2.09, Not Ranked), Delloyd Ventures Bhd (DV MK, MYR1.85, Not Ranked), Tracoma Holdings Bhd (TRAH MK, MYR0.53, Not Ranked), Hirotako Holdings Bhd (HIRO MK, MYR0.56, Not Ranked), Sunchirin Industries (M) Bhd (SCR MK, MYR0.92, Not Ranked), Sapura Industrial Bhd (SAPU MK, MYR0.30, Not Ranked) and New Hoong Fatt Holdings Bhd (NHF MK, MYR1.63, Buy).

The autoparts vendors are largely dependent on the domestic automotive industry. Total industry volume (TIV) rose to 487,176 units in 2007 from 343,173 units in 2000. However, the peak was actually in 2005 where TIV hit 552,316 units. Since then, sales dipped to 490,768 units in 2006 and 487,176 units in 2007. The lackluster performance was in part attributed to fuel price hikes, stricter loan approval process and potential buyers adopting a wait-and-see attitude.

Proton's market share too, has faltered to 24% in 2007 from high of over 50% in the early 2000s. Perodua, however, managed to increase its market share over the years and even overtook Proton as the top carmaker in 2006 in terms of units sold, thanks to its popular model, the MyVi. As at end-2007 Perodua's market share stands at 33%. Meanwhile, trailing Perodua and Proton are Toyota (17%), Honda (6%) and Naza (4%).

Things are beginning to look up at Proton again in recent times where its latest two models – Persona and Saga – are recording healthy bookings with favorable feedback from customers. In fact, the Persona and Saga have bookings in excess of 40,000 units and 30,000 units respectively.

The Malaysia Automotive Association (MAA) maintains a positive outlook for 2008, targeting a TIV growth rate of 5% to 510,000 units. The optimism is premised upon civil servant pay hike in mid-2007, rollout of new models especially in the lower engine capacity segment at attractive pricing, full sales impact of models rolled out in 2H07 (such as Proton Persona, Toyota Vios, Perodua Viva and Nissan Latio), less stringent hire purchase approvals and attractive financing rates. Nonetheless, we believe moderating factors are uncertainty in fuel prices and other inflationary pressures.

Electronic Water Meter

In Oct. 2007, EPMB completed the acquisition of the entire interest in CRN for a cash consideration of MYR38.5 mln and this marked the group's foray into the electronic water meter business. The acquisition came with a profit guarantee amounting to MYR15 mln for financial years 2007 and 2008, and MYR9 mln for financial year 2009.

EPMB is now the exclusive manufacturer of patented electronic water meters (SmartMeter™) for Severn Trent Metering Services Ltd (STMS) sold worldwide. Under the agreement, EPMB via CRN is also granted the exclusive distribution rights of SmartMeter™ for various countries in the Asian region. CRN currently holds the tax-exempt pioneer status till 2010.

STMS, which is a division of Severn Trent Plc (SVT LN, GBP14.11, Not Ranked) listed on the London Stock Exchange, is the largest water operator in the USA and second largest in the UK. With over a million units in operation worldwide, SmartMeter™ operates electronically (instead of mechanically) without any moving parts, and is therefore not affected by the wear and subsequent accuracy problems caused by grit and particulates. This, in turn, would help reduce non-revenue water (NRW) losses, which stands at close to 40% in Malaysia. In addition, as it is made of plastic and electronic components instead of brass and mechanical parts, it is also less prone to theft.

At present, CRN manufactures SmartMeter™ for STMS for the latter's sales in the UK, USA and Middle East. It supplied some 200,000 units to STMS in 2007. Locally, it is in ongoing discussions with various state authorities to encourage the use of electronic water meters to tackle the NRW issue. We understand there are some pilot projects in Malacca, Kedah, Putrajaya, Pahang and Sarawak. Management is also actively conducting trials in Australia, Vietnam, Jakarta and Thailand, and has obtained initial orders from the South Korea. CRN currently has annual production capacity of 500,000 units and management estimates production to reach maximum capacity in 2011.

Earnings Outlook

Both the automotive and automotive components industries are a volume game considering profitability is in the single-digit margin range. Hence, when sales volume at Proton fell last two years, many autoparts companies were affected as well. Nevertheless, it appears of late that Proton has been able to introduce right models at the right price that captures buyers' interest. With the revival in sales at Proton and the expected recovery in domestic automotive industry, we believe EPMB's automotive division is set to turn over a healthy profit this year.

We understand EPMB's revenue per car set for Proton ranges from MYR1,500 to MYR3,000 depending on the respective models. The group is the sole supplier to Proton for selected components such as the IAFM and corner modules. IAFM, which is a new product at EPMB, is a high value and high margin item used in both Saga and Persona. We expect it to be a significant revenue contributor this year judging from the expected sales of Saga and Persona. Meanwhile, EPMB also stands to benefit should Proton succeed with its venture in China. The national carmaker aims to export over 20,000 units of re-badged Gen-2 cars to China and has thus far delivered some 2,000 units.

On the other hand, revenue from Perodua too, has been increasing albeit at a slower pace, as evident by the higher contribution from Perodua in 2007. We understand that EPMB's revenue per car set for the newer models such as Viva and Myvi is much higher as compared to Kancil, Kenari and Kelisa previously.

Going forward, both Proton and Perodua have drawn up their new/face-lift models rollout plan till 2011, and EPMB will continue to play its role as a Tier-1 vendor. As for the export market, EPMB continues to strengthen its alliance with its partner in the Middle East to supply more parts for Toyota models sold there.

In 2007, EPMB posted a revenue of MYR303 mln but incurred a marginal loss MYR0.5 of mln. Nonetheless, signs of improvement are clear with the group registering a net profit of MYR3.0 mln and MYR2.9 mln in 3Q07 and 4Q07 respectively, offsetting the loss incurred in 1H07.

The risk factors now hinge on the execution ability, both at EPMB and Proton. Proton must not experience major production hiccups which would delay delivery, causing buyers to cancel their bookings. Similarly for EPMB, any major production glitches will likely affect earnings.

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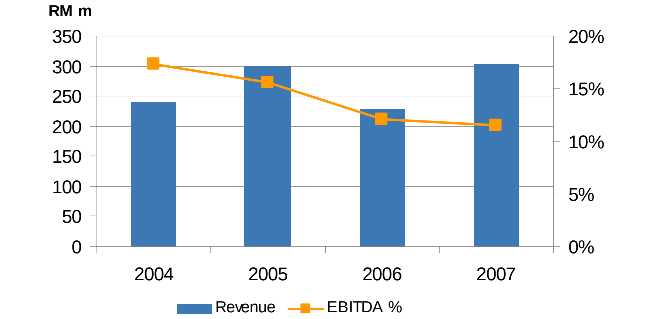
On the water meter business, we believe operating profit margin is in the mid-teens range. Based on historical trends, we continue to assume demand from STMS to be in the region of 250,000 units. Meanwhile, the use of water meter locally involves approvals from the state governments and in light of the recent political developments in Malaysia, there is possibility EPMB will experience delays. As such, we only factor in a conservative 100,000 units for local sales this year. With this, we assumed the combined profit guarantee of MYR15 mln for 2007 and 2008 will not be met and that the CRN vendors will have to make up the shortfall. Should this happen, the amount will be captured in EPMB's 2009 accounts as it is only determined after the release of the 2008 audited accounts.

For those states now in the hands of DAP-PKR-PAS alliance, EPMB will likely have to re-present its business case merits and it will take some time before any concrete result materializes. Competitors include George Kent (M) Bhd (GKEN MK, MYR0.48, Not Ranked) which is currently the largest supplier of water meters in Malaysia.

EPMB historical financial performance



We forecast a turnover and net profit of MYR357.8 mln and MYR13.9 mln respectively in 2008. Its automotive division is still expected to contribute the bulk of revenues at approximately 90%. We expect improved automotive division profitability with the contribution of high value component, IAFM, kicking in this year.

In 2009, we project revenue to grow by 10.6% YoY to MYR395.8 mln with net profit to reach MYR22.8 mln (+64.4% YoY). The larger than proportionate growth in net income is premised upon attainment of greater economies of scale in both automotive and water meter businesses as volumes increase. We estimate higher sales of new Saga and increased revenue per car set for Myvi in 2009 (arising from further localization of components manufacturing by Perodua). Meanwhile, water meters sales are estimated at 400,000 units. We have also factored in as estimated RM5 mln contribution from the CRN vendors to top up the potential shortfall in profit guarantee.

On taxation, we have assumed a low effective tax rate of 3% for 2008 and 2009. We understand from management that its key subsidiaries enjoy various tax incentives such as 100% tax exemption under pioneer status (PEPS JV and CRN), investment tax allowances on capex, reinvestment allowances and tax losses brought forward. EPMB is also confident of obtaining approval for its pioneer status application for IAFM. As such, management does not foresee substantial tax payable over the next few years.

EPMB has approximately MYR8.1 mln Irredeemable Convertible Unsecured Preference Shares (ICUPS) and MYR0.2 mln Redeemable Convertible Secured Preference Shares (RCSPS) outstanding, which are due to expire in June 2008. Upon expiration, all remaining ICUPS and unredeemed RCSPS will be converted into ordinary shares in EPMB. Upon conversion, its fully diluted share base will increase by 34% to approximately 166 mln. Our 2008 net profit of MYR13.2 mln translates into a fully diluted EPS of 8.0 sen.

Meanwhile, as at Dec. 2007, the group's net gearing stood at 1.2x. The relatively high gearing is not uncommon in this industry due to intensive capex requirements. We expect EPMB's borrowings to remain at the current level over the next two years. Under the covenants for its bond borrowings, the group's gearing ratio shall not exceed 1.5x. We are also comforted by its healthy net operating cashflow at MYR111.7 mln in 2007 vs MYR28.0 mln in 2006, with net interest cover at 2.3x.

EPMB halted its dividend payment in 2006 and 2007 due to slowdown in business and the need to conserve cash. Prior to that, it has been paying dividends annually. Management intends to resume dividend payment in 2008 upon the recovery in business. We have imputed a 1.5 sen and 3.0 tax exempt dividend for 2008 and 2009 that translates into a payout of 18% and 22% respectively.

Valuation

We have included Delloyd Ventures Bhd and APM Automotive Holdings Bhd as comparison to EPMB. Others such as Ingress Corporation and Tracoma Holdings are still in the red, while New Hoong Fatt's focus is more in the replacement market instead of OEM.

Comparative Valuations

	EPMB	Delloyd Ventures	APM
Bloomberg Code	EPMB MK	DV MK	APM MK
Share Price @ Mar 19, 200	0.44	1.85	2.09
Currency	MYR	MYR	MYR
Mkt. Cap (mln)	54.7	164.4	421.3
Ave. Daily Vol. ('000)	86	25	129
PER FY07 (x)	nm	12.3	7.8
PER FY08 (x)	5.0	21.0	6.9
P/B	0.3	0.6	0.7
Yield (%)	6.8	3.8	6.2

Source: Bloomberg, Company data

We derive a 12-month target price of 60 sen for EPMB by pegging our projected 2008 fully diluted EPS of 8.3 sen against a target PER of 7x. The 7x PER is benchmarked against APM's 2008 valuation as we feel Delloyd's valuation is on the rich side. Our target price also includes a forecast 1.5 sen tax-exempt dividend.

We believe EPMB's performance is set to turn around this year riding on the improved performance of Proton; new significant revenue from IAFM; increased sales to Perodua; and maiden contribution from its water meter business. As such we believe EPMB is currently undervalued trading at an attractive 2008 PER of 5x coupled with a projected healthy net dividend yield of 3.4%.

Recent Developments

Feb. 2008: EPMB's 4Q08 revenue and net profit came in at MYR100.9 mln and MYR2.9 mln respectively. For the full year, the group incurred a MYR0.5 mln loss on MYR303 mln revenue.

Dec. 2007: Malaysian Rating Corporation Bhd has reaffirmed the $MARC2_{ID}/A_{ID}$ rating for both its MYR150 mln Murabahah Notes Issuance Facility/ Islamic Medium Term Notes Facility (MUNIF/IMTN) and MYR120 mln MUNIF/IMTN issues.

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Profit & Loss

FY Dec. / MYR mln	2006	2007	2008E	2009E
Reported Revenue	228.5	303.0	357.8	395.6
Reported Operating Profit	11.6	15.2	30.7	40.4
Depreciation & Amortization	-15.9	-19.7	-22.3	-23.6
Net Interest Income / (Expense)	-5.2	-14.8	-14.9	-15.2
Reported Pre-tax Profit	6.4	0.4	15.8	25.2
Effective Tax Rate (%)	28.7	NM	3.0	3.0
Reported Net Profit	2.9	-0.5	13.9	22.8
Reported Operating Margin (%)	5.1	5.0	8.6	10.2
Reported Pre-tax Margin (%)	2.8	0.1	4.4	6.4
Reported Net Margin (%)	1.3	-0.2	3.9	5.8

Source: Company data, S&P Equity Research

Balance Sheet

FY Dec. / MYR mln	2005	2006	2007
Total Assets	438.8	508.0	597.9
Fixed Assets	215.3	304.4	349.7
Current Assets	131.5	108.7	100.2
Other LT Assets	91.9	95.0	148.0
Current Liabilities	125.4	144.3	217.9
LT Liabilities	340.8	391.4	414.2
Share Capital	130.1	131.5	131.6
Shareholders' Funds	205.7	202.2	199.6

Source: Company data

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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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STANDARD & POOR'S

Recommendation and Target Price History

Date	Recommendation	Target Price
New	Strong Buy	0.60