# Top Story

## TEXCHEM RESOURCES (RM1.57) — BUY

*Good things come in small packages* — **Target Price: RM1.76**

### STOCK & SHAREHOLDERS' DATA

| | |
|---|---|
| **Bloomberg Code** | : TEX MK |
| **Reuters Code** | : TEXC.KL |
| **Market Capitalisation** | : RM194.8m |
| **KLCI** | : 904.51 |
| **Paid-up Capital** | : 124.1m |
| **Free Float (est)** | : 38.2% |
| **Range 12 mths** | : RM1.05-RM1.60 |
| **Daily turnover (3 mth)** | : RM0.06m |
| **Relative Performance** | : 1-mth +4.1%<br>3-mth +10.9%<br>6-mth +43.1%<br>12-mth +17.9% |
| **Major Shareholders** | : |
| Texchem Holdings | 33% |
| Texchem Corporation | 17.5% |

### INITIAL COVERAGE

| YE 31 Dec | 2004A | 2005A | 2006F | 2007F | 2008F |
|---|---|---|---|---|---|
| Pretax profit (RMm) | 11.0 | 25.5 | 34.0 | 44.3 | 56.6 |
| Net profit (RMm) | 3.9 | 18.7 | 23.5 | 27.6 | 31.1 |
| *Revision (%)* | | | *New* | *New* | *New* |
| *Consensus (RMm)* | | | *n.a.* | *n.a.* | *n.a.* |
| FD EPS (sen) | 3.2 | 15.0 | 18.9 | 22.2 | 25.1 |
| EPS Growth (%) | (13.9) | 374.7 | 26.0 | 17.2 | 13.0 |
| CFPS (sen) | 23.4 | 40.5 | 44.4 | 47.6 | 50.5 |
| Gross DPS (sen) | 8.0 | 10.0 | 13.0 | 15.0 | 17.0 |
| NTA / Share (RM) | 0.90 | 0.95 | 1.02 | 1.13 | 1.26 |
| PER (x) | 49.6 | 10.4 | 8.3 | 7.1 | 6.3 |
| P/CFPS (x) | 6.7 | 3.9 | 3.5 | 3.3 | 3.1 |
| Gross yield (%) | 5.1 | 6.4 | 8.3 | 9.6 | 10.8 |
| P/NTA (x) | 1.7 | 1.7 | 1.5 | 1.4 | 1.2 |
| ROE (%) | 2.5 | 11.5 | 13.7 | 14.9 | 15.6 |
| EV/EBITDA (x) | 6.9 | 4.6 | 3.4 | 2.4 | 1.5 |

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### INVESTMENT CASE

- **Asia's leading manufacturer of high-technology plastic packaging materials.** Texchem is the leader in Asia in the manufacture of thermoformed trays, extruded sheets and profiles and precision injection moulded products for the semiconductor and hard disk drive industries. It count among its customers some of the best-known multi-national corporations in the world, such as Seagate, Solectron, Nidec and Sony. In addition, management's efforts to diversify its product range, through strategic partnerships with Japanese and American companies, would enable Texchem to secure more multi-national corporate clients as well as boost the profitability of its Packaging division.

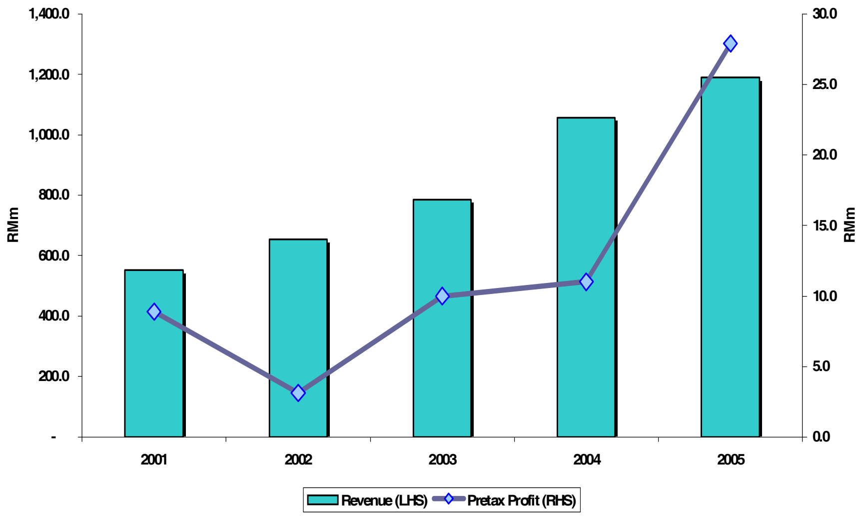
- **An indirect play on the booming semiconductor industry.** The group's Packaging division is well-positioned to capitalize on the current upswing in the electronics industry in 2006, particularly in the semiconductor and hard disk drive (HDD) segments, where the group has well-developed product offerings.

- **Benefitting from scale at Indonesian insecticide operations.** Its Household insecticide manufacturing associate (49.9%-owned) in Indonesia is poised for explosive growth, given that country's huge domestic market. Earnings growth is forecast to be very strong in the next few years with the Indonesian associate's low-cost structure and with sharp margin expansion expected from scale economies (as sales volumes in Indonesia increase).

- **Turnaround in food division from FY07.** The Food division is expected to break-even in FY06 and return to profitability in FY07 [after two years (FY04-05) of pretax losses, albeit small]. This would be largely attributable to measures taken by Texchem to reduce fuel costs at its surimi-manufacturing subsidiary in Myanmar, such as a biomass boiler, as well as measures to increase production, such as a new ice factory and two new fish meal lines in 1H 2006. In addition, production would also be more consistent with assured supply of raw fish.

- **Strong growth and value story.** We forecast the group will post a net profit of RM23.5m in FY06, up by 26% from FY05. This translates into an EPS of 18.9 sen or a PER of 8.3x - very attractive for a company with earnings that is growing at a CAGR of +18.6% from FY05 to FY08.

**TEXCHEM GROUP: HISTORICAL REVENUE AND PRETAX PROFITS**




## Leading Manufacturer Of High-Tech Plastic Packaging Materials In Asia

**Asia's biggest.** Texchem is Asia's leading manufacturer of high technology plastic packaging materials, providing packaging solutions to the consumer electronics, semiconductor, data storage and telecommunications industries.

**Blue-ribbon clientele.** The majority of its customers are multinational companies that sell their products worldwide, such as Seagate, Solectron, Nidec and Sony. Texchem's packaging products are exported to countries such as the United States, Japan and the Philippines.

**Evenly-balanced customer groups.** Packaging products for its semiconductor customers make up about 37% of the total revenue for the packaging division, while consumer electronics and data storage make up about 28% and 24%, respectively.

**Best-performing division.** The Packaging division is the biggest contributor to the Texchem group's pretax profit, contributing 41% to group PBT in FY05 and approximately 61% in 1Q06.

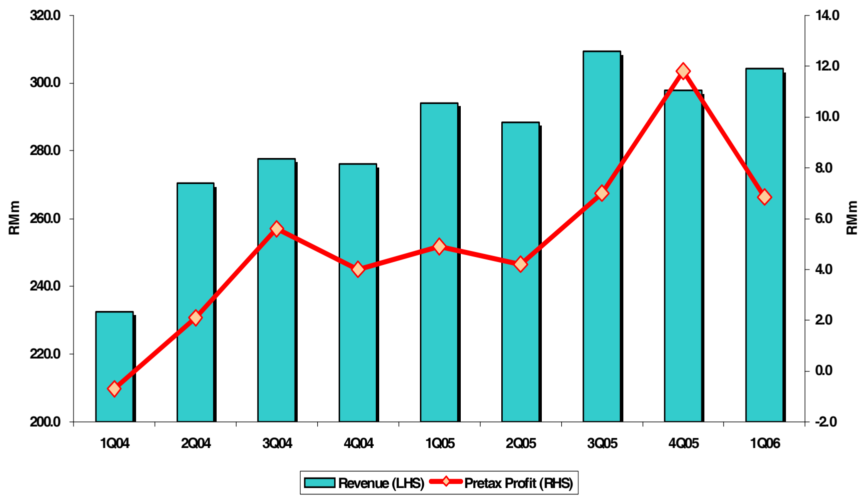
**Rapid expansion in margins.** Revenue grew +73% to RM222m YoY in FY05 but pretax profit (PBT) jumped by an even bigger percentage (+229% YoY) to RM13m. Pretax profit margin for this division improved to an estimated 8.7% in 1Q06 from 5.6% in FY05 and 3.0% in FY04.

**Strong sequential growth.** On a quarterly basis, this division is estimated to have shown a sharp increase in pretax profits from RM2.7m in 4Q05 to RM5.4m in 1Q06. PBT margin is estimated at 8.7% in 1Q06, almost doubled from 4.6% in 4Q05.

**Proactive cost control management.** And this was despite the challenging environment and escalating costs of materials linked to the price of crude oil, such as resin compound. Essentially, cost control measures instituted by management throughout the division and their efforts to improve operational efficiencies had helped mitigate the escalating costs of materials.

**Wide range of specialised products.** Texchem is engaged in the manufacture and sale of a variety of plastic packaging products, ranging from thermoformed trays, embossed carrier tapes, extruded sheets and profiles and precision injection-moulded products to expanded polystyrene products.

**TEXCHEM GROUP: QUARTERLY REVENUE AND PBT TREND**




**Strategic alliances helped.** The group had introduced new packaging options and technological enhancements to complement the division's integrated product offering. Such alternatives were built on strategic alliances with technology partners.

Texchem has formed strategic partnerships with two Japanese and three American companies for technology collaboration, which are geared towards providing innovative and comprehensive packaging solutions.

**Diversifying into new products.** These strategic partnerships and tie-ups would enable Texchem to move up the technical capability ladder, and hence the value chain, in packaging technology, which in turn would help it to introduce new packaging products, secure new multi-national corporate clients and further enhance the division's profitability in the medium- to long-term. More importantly, it would also diversify this division's over-reliance on the semiconductor and data storage (hard disk drive) industries.

**Not just a manufacturer but designer too.** Texchem's competitive advantage in packaging products lies in its design and mould-making capabilities. The group has an in-house research and development (R&D) unit that provides design services to multinational companies (MNC).

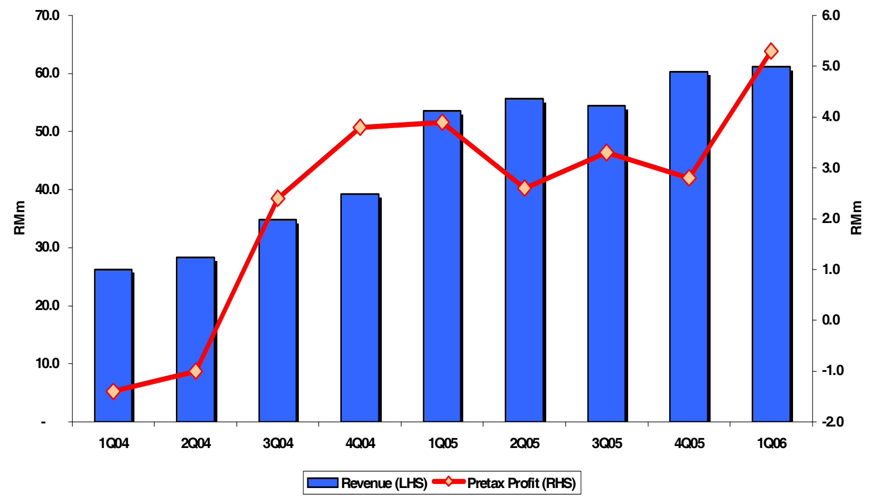
**One-stop service provider.** This is important as the MNC customers sometimes merely provide Texchem with only a product sample (i.e., the end-product) without giving any technical specifications, and Texchem is expected to design and manufacture the packaging.

**Technical expertise a barrier to entry.** While such packaging products may appear basic and simple to manufacture to the uninitiated, some of them do require very high manufacturing standards as they are used in the semiconductor, hard disk drive (HDD) and electronics industries, where accuracy and cleanliness (contamination as measured in parts per million) are paramount.

**Help from academics.** It helps that Texchem has a research and development collaboration agreement with Tokyo Institute of Technology and University of Akron in the United States in the area of polymer design and engineering and compound development.

**Makes moulds too.** In addition to design services, Texchem also has the capability to make the moulds that are necessary to manufacture the packaging products. In fact, almost all of its moulds are made in-house.

**PACKAGING DIVISION: QUARTERLY REVENUE AND PBT TREND**




*Source: AmResearch*

**Geographically diversified.** Within the Packaging division, the group has ten (10) manufacturing companies, with nine (9) strategically located across the ASEAN region and one (1) in Wuxi, China.

[N.B.: Texchem Resources Bhd has re-submitted an application for admission of its subsidiary, Texchem-Pack Holdings (S) Ltd, to the Official List of the Singapore Exchange Securities Trading Ltd Main Board on 31 Mar 06].

## Indirect Play On Booming Semiconductor Industry

**Major player in semiconductor and HDD industries.** The Packaging division is set to capitalize on the upswing in the electronics industry in 2006, particularly in the semiconductor and hard disk drive (HDD) segments, where the group has well-developed product offerings.

**In good position to benefit.** With Thailand's emerging status as the world's leading HDD producer, the group is expected to leverage on its established operating base in that country to further enhance the growth of its packaging business.

## Benefitting From Scale At Indonesian Insecticide Operations

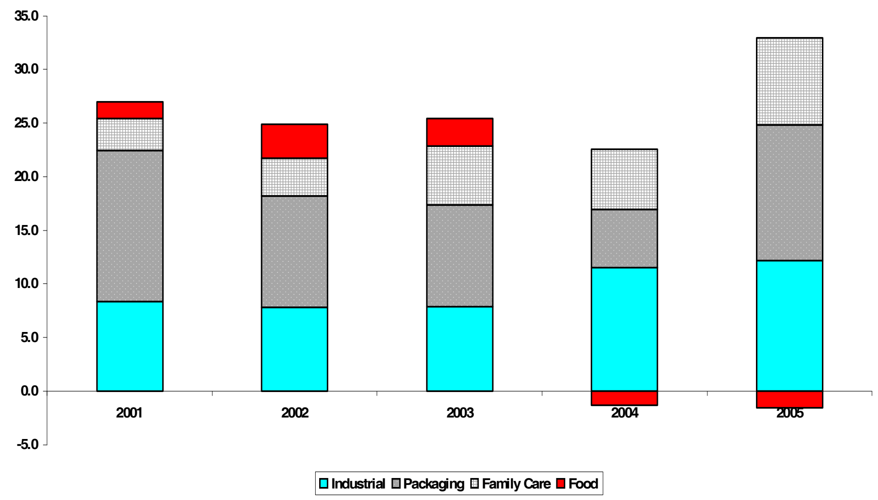
There are two main sub-segments within the Family Care Division: Consumer Products and Household Insecticides.

**Major player in another segment.** Texchem is the second largest player in the fast-moving consumer goods (FCMG) trading business in Malaysia, after DKSH (Diethlem). Currently, Texchem represents 28 principals and distributes a wide range of packaged goods, including household provisions and insecticides, toiletries, personal care products, food, confectionary and beverages.

It distributes as many as 400 stock keeping units (SKU) and offers the widest trade coverage in Malaysia with over 20,000 retail outlets that are serviced by its sales force every month.

**Sole distributor.** Among some of the brands that it has sole distributorship rights in Malaysia are *Johnson*, *Schweppes*, *Lego*, *Disney*, *Hudson's*, *Good Maid*, *Cuticura* and *Pillsbury*.

**PRETAX PROFIT CONTRIBUTION BY THE VARIOUS DIVISIONS**




*Source: AmResearch estimates*

**Low-margin business; scale very important.** However, the Consumer Products distribution business is a very thin margin business, with its subsidiary, Texchem Consumers Sdn Bhd, occasionally slipping into the red, especially in the first-quarter of each year. The first-quarter is traditionally weak because of the festive season (most customers buy their requirements in the preceding quarter; hence the fourth-quarter is usually the strongest). Economies of scale are thus absolutely critical in the distribution of FMCG business.

Its Household Insecticides segment in Malaysia, Fumakilla Malaysia Bhd, manufactures an extensive range of household products, including mosquito coils, mosquito mats, insecticidal aerosols, liquid and mat vaporizers, rodenticides and air fresheners.

The Household Insecticides segment is the biggest contributor in the Family Care Division, accounting for nearly all of the Family Care division's pretax profits. PBT margin at Fumakilla Malaysia is between 8-9%.

The group also has manufacturing facilities in Indonesia, Thailand, Vietnam and Myanmar, as well as a strong presence in Cambodia and Laos. Its 49.9% associate, PT Technopia Jakarta, has one of the largest insecticides manufacturing plant in the division.

In addition, it is a low-cost producer of insecticide products. But more importantly, the Indonesian market is many times bigger than Malaysia's, and PT Technopia Jakarta is not even near its potential yet.

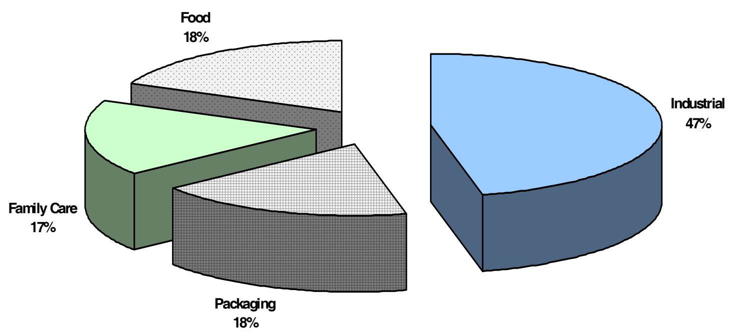
PT Technopia Jakarta is poised for explosive growth, given that country's huge domestic market. Earnings growth in the coming years would be very strong with the company's low-cost structure and with sharp margin expansion expected from scale economies (as sales volumes increase).

In terms of volume, PT Technopia Jakarta sells three times (3x) more than Fumakilla Malaysia. [Note: Texchem's household insecticide products are sold under the brand name "Domestos Nomos" in Indonesia].

## Food Division Expected To Be Profitable In FY06

**Look-alike crustacean seafood maker.** Among other things, this division produces and markets surimi-based products (such as crab claws, crab sticks, crab flakes, lobster tail, scallops and prawn tail). In recent years, it has widened its product range and market base to include surimi (a high quality minced fish meat product) and fishmeal (a high protein animal feed ingredient) through 77%-owned A.S.K. Andaman Ltd ("ASK") in Myanmar.

**REVENUE BREAKDOWN BY THE VARIOUS DIVISIONS : FYO5**




**Also processes seafood.** In addition, the group is also a seafood-processing specialist with a product range that includes quality frozen marine products such as squid, cuttlefish, octopus, shrimps, prawns, jellyfish, spanner, soft shell crabs, fish as well as dried marine products.

**Downstream activities as well.** The Sushi King restaurant chain, Malaysia's largest sushi restaurant chain, is a significant revenue and profit contributor for the Food division, making up approximately 23% of the Food division's turnover in FY05 and is one of only two subsidiaries in this division to post profits. As at the end of 2005, there were 34 Sushi King outlets throughout Malaysia.

**Bright prospects.** The prospects for its Food division are very good; the industry is relatively recession-proof and worldwide demand is rising fast.

**Demand for seafood exceeds supply.** Consumption of seafood is growing at a fast pace. In Europe, demand for seafood is apparently growing at 6% per annum while in the United States, demand is growing at 3% per annum. But the biggest potential is China, whose population currently consumes fewer quantities of seafood on a per capita basis compared to Malaysians.

**Surimi not making money.** However, the Food division's profitability in FY05 and 1Q06 were adversely affected by its loss-making surimi-manufacturing operations in Myanmar, namely ASK, which in turn was due to escalating fuel costs and difficulties in obtaining sufficient supplies of raw fish for the production of surimi. [If not for ASK, the Food division would have chalked pretax profits].

**Cheap energy source as an alternative.** To mitigate the increase in fuel prices, a biomass boiler has been installed in the Myanmar plant. This biomass boiler was commissioned in the later part of the first quarter of 2006.

**Capacity expansion to drive division earnings.** In addition, a second fishmeal line plus the newly constructed ice plant at ASK have commenced operations in early 2Q06. Renovations to the plant are also in progress for the processing of value-added products. These additional investments and initiatives are expected to boost the revenues and profit margins of the Myanmar operations.

ASK will benefit from economies of scale now that this second line, which can process an additional 600 tons of fishmeal per month, has started operations in 2Q 2006.

**No looking back from FY07 onwards.** Given the above developments and initiatives by management, this Division could potentially become the biggest contributor to Texchem group's pretax profit by the year 2010.

**A noteworthy point.** Its Malaysian subsidiary, Texchem Food Sdn Bhd, has International Procurement Center (IPC) status in Malaysia, which qualifies the company to be exempted from corporate taxes for a period of 10 years.

## Biggest Chemicals And Dyestuff Trader In Singapore And Malaysia

**Biggest but not the most profitable division.** This is the biggest division in terms of revenue contribution for the Texchem group, accounting for 47% of total group revenue in both FY05 and 1Q06. The group is mainly a trader in plastics resins, industrial chemicals, textile processing chemicals and dyeing auxiliaries, i.e., it represents foreign as well as local manufacturers to market and distribute their products.

**Market leader in yet another industry.** But its trading activities are not just confined to Malaysia. Instead, Texchem markets and distributes to all the main countries in ASEAN, such as Malaysia, Singapore, Thailand, Vietnam and Indonesia. In fact, Texchem is a market leader in Malaysia and Singapore.

**But margins are very thin.** Because of the *trading* nature of this division's business model (as opposed to *manufacturing*), its pretax margin is razor thin at only 2.0% in FY04, 2.1% in FY05 and approximately 1.9% in 1Q06.

**Sales flat.** Revenue growth was also relatively flattish at only +3.5% in FY05 (from FY04) and is estimated to have contracted in 1Q06 (compared with 1Q05) by about -5.3%.

**Another business division that relies on scale.** In other words, it is purely a volume game here with scale playing a major role in this division (Industrial)'s profitability.

## RISK FACTORS

- Texchem does not have official exclusivity in Malaysia over the materials that it imports from suppliers such as ShinEtsu, ExxonMobil and Taiwan Synthetic Rubber Company. In other words, these suppliers are at liberty to supply their chemicals and chemical products to anyone else in Malaysia that might be interested to purchase from them, though traditional market practice and long-term relationships do play an important role.

  Neither does Texchem enter into long-term purchase contracts with these suppliers. That said, these suppliers have been supplying plastic resins and chemicals to Texchem for the last 25 – 30 years. Thus, the risk that these suppliers may one day stop supplying to Texchem is, in our opinion, relatively low.

- The spiralling price of crude oil would have some impact on the price of resin compound, which is the main raw material used in the manufacture of packaging products. Raw materials make up about 65% of the total cost of production.

That said, the price of resin is not solely dependent on the price of crude oil. Instead, the price of resin is more dependent on the dynamics of demand and supply of resin. In a rising price environment, suppliers of resin would be more reluctant to sell too far forward.

However, Texchem enjoys bulk discounts on resin compounds, as it is one of the largest consumers in the region. No other competitor has so many factories in the region.

- The profitability of the Food division is vulnerable to its harvest from the sea. Its products are basically consumer perishables and thus have a high degree of wastage. Pretax margin for this division is thus quite low at between 2 - 3%.

- It is also affected by high diesel prices, as its seafood processing / surimi-manufacturing factory in Myanmar is very dependent on diesel as its primary source of fuel for its boilers.

- The sluggish domestic textile industry, which resulted in lower demand from the local market, has had a direct negative impact on the group's manufacturer of textiles auxiliary chemicals subsidiary (Industrial division). However, the group is addressing this by stepping up marketing efforts overseas. This has resulted in increased export sales to neighboring ASEAN countries and China in recent times.

- The group is exposed to foreign exchange risk. The group pays for its imports of plastic resins, synthetic polymers, dyestuff, etc. in US Dollars (USD) but sells them to Malaysian customers in Ringgit (RM). A stronger Ringgit would thus be disadvantageous to the group's revenue and bottom-line. The group does not enter into any forward exchange contracts to hedge its foreign exchange risk.

- The stock has extremely low liquidity. Average daily turnover was only RM35,000 or 27,000 shares in the last 12 months. The stock's velocity is barely 13% of its estimated free float of 47.4m shares (38.2% of its paid-up capital).

## VALUATION & RECOMMENDATION

**No peers.** While there are companies listed on Bursa Malaysia that manufactures and sells agricultural chemical products (such as **Ancom Bhd**) or that manufactures chemicals and methyl chloride (such as **Batu Kawan Bhd**), there are strictly no comparable companies listed on Bursa Malaysia (that are involved in the same business activities that Texchem is in). It is therefore not possible to carry out a meaningful relative valuation of Texchem.

**A strong growth stock.** In view of this, we think the preferred valuation methodology would be the PE-to-growth (PEG) ratio. Texchem's 3-year forward (FY05 to FY08) EPS CAGR is 18.6% (based on our forecasts). Assuming a PEG ratio of 0.5x, this would translate into a PER of 9.3x on FY06 EPS of 18.9 sen, which in turn would give us a fair value of **RM1.76** (suggesting a potential capital gain of 12%).

**A dividend play too.** However, we expect Texchem to pay relatively attractive dividends. We are assuming a net dividend payout ratio of circa 50% of EPS by Texchem, giving us dividend per share of 13.0 sen, 15.0 sen and 17.0 sen for FY06 to FY08, respectively. These translate into very attractive gross dividend yields of between 8.3% to 10.8%.

**Initiate with a BUY.** Given that the expected total return on Texchem is 20.4% for 2006 (which is above our hurdle rate of 15%), we are initiating coverage on Texchem Resources Bhd with a **BUY**.