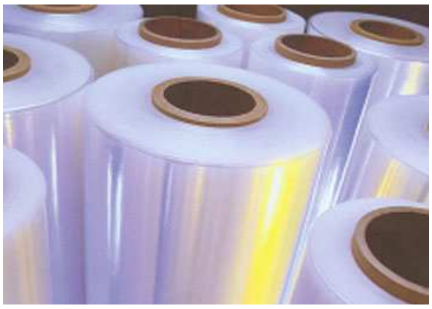
Plastics & Packaging

Valuation Re-Rating

OVERWEIGHT
↑

By Marie Vaz / msvaz@kenanga.com.my;

Upgrade to **OVERWEIGHT** (from NEUTRAL**)** as we believe the plastic sector will fare well for investors in coming quarters with industry favourable macroeconomic factors such as resin cost and exchange rates remaining largely unchanged. However, we believe a sector re-rating is due, driven by strong demand as evident from capacity expansions as well as margin growth through higher value products from improved product mix, while recent quarterly results improved YoY beating analyst expectations, with share price gains of 30-43% YTD, exceeding the broader market (FBMKLCI -2% YTD), and FBM Small Cap (-5% YTD), making the sector a preferred haven for investors, especially in coming quarters. We are increasing our valuations and re-basing it against DAIBOCI as valuations have remained sticky at 18.0x average Fwd. PER since CY14 on above-average margins and ROE vs. its peers back then, and despite earnings declines (-13%) in CY14; while other plastic manufacturers are fast playing catch-up in terms of margins and earnings growth. Based on our analysis and using DAIBOCI as a base, we reckon that SLP deserves richer valuations of 21.5x FY17E PER, while SCIENTX should be valued at 17.6x CY17E PER and TGUAN at 14.6x FY17E PER. As a result, we upgrade our call for SCIENTX, resulting in all Plastic Manufacturers under our coverage warranting an **OUTPERFORM** call on higher TPs; **SCIENTX (TP: RM15.13)**, **SLP (TP: RM3.11)**, and **TGUAN (TP: RM4.49)**. Our Top Picks are SCIENTX and SLP on strong upsides from current levels. While the sector has fared well over the last one year, the sector is rerating given the changes in demand needs for flexible packaging. Longer-term prospects remain positive on continued capacity expansion and TPPA.



1Q16 results above expectations, again. 1Q16 results came in above our and consensus, for TGUAN and SCIENTX, mainly due to better-than-expected net margins from higher export sales and stronger contribution from premium products, and lower effective tax rates for SCIENTX, while SLP came in within expectations. This is only slightly worse off than 4Q15 where all plastic manufacturers under our coverage exceeded expectations. Additionally, resin cost remained stable during the quarter. All in, we upped our earnings for TGUAN (28-26% in FY16-17E) for the third time in a row and SCIENTX (12-20% in FY16-17E) for the fourth time in a row to be more reflective of better margins, while SLP was left unchanged.

One of the few sectors that recorded strong YTD performance of 30-43% in 1H16. Plastic packaging companies performed well in 1H16, as stocks under our coverage rallied by 30%-43% on stronger margins YoY as highlighted above. This sector remains one of the few sectors that performed above analyst expectations in the two recent results season, beating the FBM KLCI's YTD of -2%, FBM Small Cap Index's YTD of -5% and even the rubber gloves companies of between -26% to -32%. The plastic sector is expected to remain resilient in coming quarters supported by stable macroeconomic fundamentals (i.e. low resin cost and favourable forex).

Long-term earnings growth through expansion and product development. To recap, we noted that packagers SLP and SCIENTX are still planning to grow capacity beyond current levels, with SLP planning a new manufacturing facility to fully materialise by FY18, while SCIENTX intends to double the capacity at its newly acquired Ipoh plants, which have already begun contributing to earnings in its most recent quarter (2Q16, announced on 22nd March 2016). We expect the continued expansions to ensure long-term earnings growth beyond FY18E. Note that we have already priced in such plans for companies that have finalised details such as timeline and production capacity. TGUAN is not aggressive on capacity expansion but is consistently investing in R&D to improve sales and margins on existing products (i.e. stretch film) and revamp its customer base and target more MNCs.

Resin cost remains stable at USD1,100-1,200MT. Resin cost has remained flattish at USD1,100-1,200MT in 1HCY16, and is expected to maintain at current levels in 2H16. Recall that one of the key determinants of lower resin price is the supply and demand dynamics of resin, which have seen a supply glut in 2HCY15 as China increased resin production capacity to support local demand. All in, we have accounted for lower resin prices for all plastic packagers under our coverage as we are now assuming USD1,100-1,200/MT in our estimates.

Maintaining USD exchange rate assumptions at RM4.10 in FY16-17. We make no changes to our USD exchange rate assumptions of RM4.10/USD1.00 in FY16-17E for all plastic manufacturers under our coverage, which is in line with the YTD average of RM4.10, and current rates of RM4.02. We are comfortable with our USD assumptions for now as going forward, we expect that the Ringgit will continue to remain weak vs. the USD due to: (i) bearish outlook on global oil prices, (ii) uncertainties in local geopolitical situation, (iii) market indecisiveness surrounding the Brexit, and (iv) uncertainties on a possible US interest rate hike in 2H16 or 1Q17, which could lead to weaker Ringgit. Additionally, we are not overly concerned as a 5% decrease in the exchange rate would translate to c.2%-4% decline in earnings for plastic manufacturers under our coverage, while growth going forward will be driven by higher margin products from better product mix and increased demand from importers.

Increasing earnings estimates for TGUAN on better margins. We are increasing our earnings estimates for TGUAN on stronger margin assumptions due to our conservative margin assumptions previously. The company has delivered sequential quarterly improvement in margins over the last four quarters, expanding from 12% gross margins to 17% with core net margins expanding from 3% to 9%. We had previously forecasted core net margins of 5.3-5.6% in FY16-17E. However, going forward, we believe TGUAN can command similar margins as: (i) the Group is selling off machinery for lower margin products such as jumbo rolls (est. <5% gross margins), while (ii) top line growth and better margins products are mostly from Maxstretch stretch film on better pricing due to improved product quality, (iii) PVC food wrap and (iv) organic noodles. As such, we are increasing our earnings estimates by 24-25% in FY16-17E to RM51.4-56.6m on conservative margin assumptions, and our EPS to 27.9-30.8sen after fully diluting our share base for warrants and ICULS.

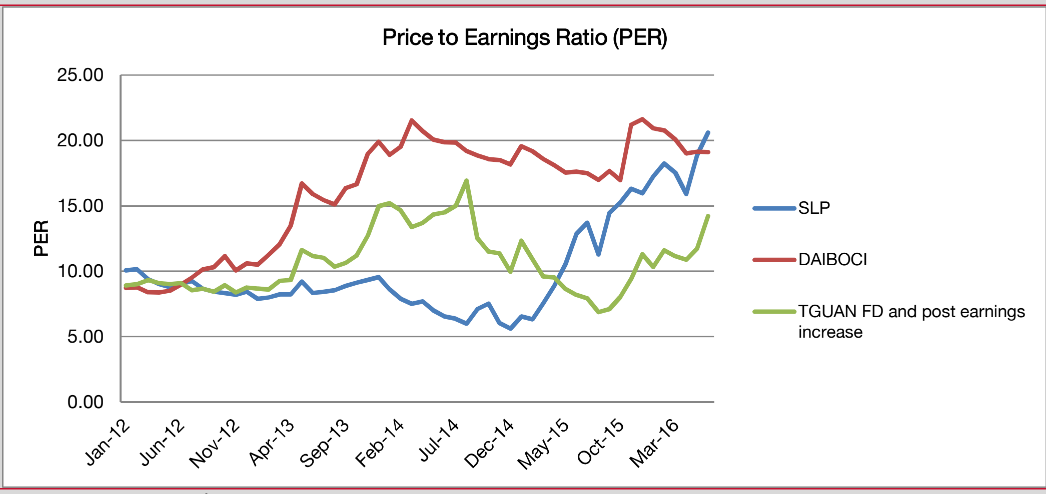
Following rubber gloves footsteps. Similar to the glove manufacturers, we believe demand for Malaysian manufactured plastic products will remain strong despite the global economic slowdown on continued strong demand from Japan, China, parts of Europe and Australia, due to the favourable exchange rates, without compromising on quality of the finished good. Meanwhile, demand for goods in both sectors (i.e. Rubber Gloves and Plastic Manufacturing) remain fairly inelastic despite a global slowdown due to the nature of the final product that is also rather inelastic of consumer spending power, for example, rubber gloves requirements for healthcare, and garbage bags, lunch boxes, stretch film and medical devices produced by plastic manufacturers, as these products are necessities to existing consumers. However, rubber gloves are slightly more superior to plastic in terms of demand due to the stringent requirements imposed on glove makers, making barriers of entry into the glove making business tougher, while plastic goods are comparatively more generic.

Evidently so, local plastic manufacturers are well aware of the increasing demand of plastic goods and have already been embarking on capacity expansions plans to match increasing demand for goods, with: (i) SLP increasing capacity by est.58% to 38,000MT per year by CY18, (ii) SCIENTX expecting capacity to increase by 42% YoY by end-FY17 to est. 306,000MT as the group has been continuously increasing capacity in the consumer packaging segment since CY14, (iii) SCGM (Not Rated) increasing capacity by 195% to 49,500MT per year by CY20, and (iv) DAIBOCI (Not Rated) is spending RM13m for expansion phase of DAIBOCI Plastic Plant 2. We believe this is somewhat reminiscent of Rubber Glove manufacturers with the new capacity expansions aim at matching resilient demand from importing countries, on the back of favourable exchange rates and low raw material prices, and as such, we believe plastic manufacturers applied PERs warrant to close in on the valuation gap to trade closer to glove manufacturers' traded PERs of 15x-25x 1 year Fwd.

A sector rerating is due. DAIBOCI's valuations have remained sticky at 18.0x average Fwd. PER despite earnings decline (-13% YoY) in FY14 to RM23.7m, which we believe is mostly due to: (i) stable demand and earnings from reputable client base (e.g. MNC clientele in F&B such as Nestle, PepsiCo (Thailand) and Mondalez, (ii), a dividend policy with a high pay-out ratio of 60% relative to other packagers that either had no policy or c.30% pay-out, (iii) ROE on the higher end vs. its peers in FY13-14 (16.7-14.0% vs. between 7.6-15.7%, save for SCIENTX at 17.5-20.8%), and (iv) higher EBIT margins in FY13-14 of 12.1-9.5% vs. its peers of 4.2%-8.9%, save of SCGM, which we believe warranted DAIBOCI's higher PERs back then. Due to the abovementioned factors, DAIBOCI has been trading at 18.0x average Fwd. PER with a tight range of 17.0-21.6x PER since CY14, vs. peers' average of 11.2x (range of 5.6x-20.6x PER).

Hence, since DAIBOCI has set a valuation basis for the sector while players like SLP, SCIENTX and TGUAN have similar, if not better, dynamics and fundamentals. Hence, it is only fair that we re-base valuations for the other players after taking into account the following factors:

DAIBOCI PER vs. Peers



Source: Bloomberg, Kenanga Research

i. Fundamental analysis

a. **EBIT Margins:** SLP is the most superior with 20%-14% as in recent quarters while we estimate 20-23% for FY16-17E vs. that of TGUAN at 9%-8% in recent quarters while we estimate 7-8% for FY16-17E, SCIENTX at 10-8% manufacturing margins in recent quarters while we estimate 8-9% for FY16-17E, while DAIBOCI recorded 10% margin in the recent quarter.

b. **Dividend pay-out**: DAIBOCI has the strongest dividend pay-out with a 60% dividend policy, followed by SLP at 40% (recently announced in FY16), SCIENTX with a 30% dividend policy and lastly TGUAN, which does not have a formal policy, but had generally paid out c.28-29%.

c. **ROE**: SLP has the highest ROE at 24% in FY15 while we estimate 23-24% for FY16-17E vs. that of SCIENTX at 19% in FY15 while we estimate 24-23% for FY16-17E, TGUAN at 10% in FY15 while we estimate 13%-14% for FY16-17E, while DAIBOCI is at 15%.

d. **3-year CAGR**: SCIENTX has the highest 3-year CAGR at 32%, followed by TGUAN at 21% and SLP at 20%, while DAIBOCI is at 10%.

e. **Balance Sheet**: SLP and TGUAN have the strongest balance sheet as both are currently in a net cash position which we expect both companies to maintain in FY16-17E, vs. that of SCIENTX with a net gearing of 0.40x in the recent quarter while we anticipate 0.42-0.23x in FY16-17E, while DAIBOCI is at 0.20x net gearing currently.

f. **Market Capitalisation:** SCIENTX has the largest market capitalisation at RM2.9b, followed by SLP at RM672m, DAIBOCI at RM574m and TGUAN at RM439m.

ii. Business segmentation and profile

a. **Export revenue:** SLP has the highest portion of revenue derived from USD-denominated sales at c.60% (63% as at the latest quarter), vs. that of TGUAN which we estimate is at c.50% of revenue, and SCIENTX at c.25%, while DAIBOCI has c.30%.

b. **Exposure to consumer segment:** SLP has the highest exposure to the consumer segment at c.70% of revenue, SCIENTX at c. 47% of total manufacturing revenue, and TGUAN at an estimated <30% of revenue, while DAIBOCI has close to 90%.

Based on the above analysis and using DAIBOCI as a base, we reckon that SLP deserves richer valuations of 21.5x FY17E PER. Meanwhile, we think TGUAN should trade at 14.6x FY17E PER, and SCIENTX at 17.6x PER on CY17E PER.

Valuations

Valuations	Previously Applied PE	Previous TP	PE Re rating based on DAIBOCI	New TP based on higher applied PE	Comment
Consumer					
SLP	15.5	2.24	21.5	3.11	Applied 21.5x PER on FY17E
DAIBOCI	n.a.	n.a.	18.4	n.a.	
Industrial					
SCIENTX	14.0	13.25	17.6	15.13	Applied PER for manufacturing segment based on Sum-of-Parts (SoP) methodology for CY17 , lowered our applied PER for property to 4.0x (from 5.0x) to CY17 RNAV
TGUAN	11.0	4.19	14.6	4.49	Applied 14.6x PER on FY17E

Source: Bloomberg, Kenanga Research

Our Top Pick is SLP with an OUTPERFORM call and TP of RM3.11 (from RM2.24). We have increased SLP's applied PER to 21.5x (from 15.5x) and believe SLP warrants to trade at a premium to DAIBOCI due to: (i) higher portion of sales in USD at 63% in 1Q16, (ii) strong EBIT margin of 14% in 1Q16 vs. peers' 7%-10%, (iii) its consistent net cash position, (iv) recently announced 40% dividend policy, and (v) strongest ROE of 24% vs. peers' 9-21%. At current levels, total returns are at 16.4%, while investors can look forward to capacity expansion plans (+58% to total capacity) in CY18.

Another Top Pick is SCIENTX with an OUTPERFORM call and TP of RM15.13 (from RM13.25). We increase SCIENTX's applied PER for the manufacturing segment to 17.6x (from 14.0x), slightly below DAIBOCI as: (i) exposure to forex is slightly lower at c.25% vs. DAIBOCI's 30%, (ii) manufacturing EBIT margins are catching up to DAIBOCI at 9.0% vs. 9.8% in the recent quarter, and (iii) 30% dividend policy vs. DAIBOCI's dividend policy of 60%. However, in terms of ROE and 3-year CAGR, SCIENTX fares better than DAIBOCI at 18% ROE vs. 15%, and 3-year CAGR of 32% vs. 10%. In terms of SCIENTX's valuations, we have also lowered our applied PER for the property segment to 4.0x (from 5.0x in CY17) due to a weaker Johor market, but the stock is commanding strong total returns of 22.4% at current levels. We have upgraded SCIENTX to OUTPERFORM (from MARKET PERFORM) and TP to RM15.13 (ex-bonus: RM7.57), from RM13.25.

Maintain OUTPERFORM on TGUAN but increase TP to RM4.49 (from RM4.19). We are increasing TGUAN's applied PER to 14.6x (from 11.0x) due to its: (i) high exposure to USD sales at c.50% of revenue, (ii) consistently improving EBIT margins that are catching up to DAIBOCI at 8.7% vs. 9.8% in 1Q16, (iii) net cash position, (iv) high 3-year CAGR of 21% vs. DAIBOCHI's 10%, (v) dividend pay-out averaging c.28%, despite no dividend policy vs. DAIBOCI's 60% dividend policy, while (vi) TGUAN's ROE is lower at 9% vs. DAIBOCI's 15%. Additionally, as mentioned above, we have increased earnings estimates for TGUAN by 24-25% in FY16-17E to RM51.4-56.6m, and our EPS to 27.9-30.8 sen on a fully diluted basis from our previously conservative margin assumptions, increasing our TP to RM4.49. TGUAN has performed well since we upgraded our call to OUTPERFROM and TP to RM4.19 (report date 27th May 2016) during its 1Q16 results, and its share price has rallied by 29% since. At current levels, TGUAN commands total returns of 10.0% as of our cut-off date. Due to TGUAN's stellar share price performance to date, we believe upsides are limited at this juncture to warrant a Top Pick recommendation and a strong buy call.

To recap, we believe SLP warrants to trade at a premium to DAIBOCI as SLP has: (i) a strong net cash position, (ii) higher growth rate, (iii) higher ROE, (iv) stronger margins, and (v) stable customer base from Japan. Additionally, we have increased our applied PERs for industrial packagers, SCIENTX and TGUAN as: (i) industrial packagers' margins are playing catch up with consumer players, (ii) stronger growth prospects due to expansion plans, (iii) leading to higher ROEs, and (iv) TGUAN is still net cash. Going forward, we will continue to monitor the low resin cost resulting from the excess supply in the market, which could lead to more margin expansions in the near-term and potentially trigger an earnings upgrade.

Upgrade to OVERWEIGHT (from NEUTRAL) as macroeconomic fundamentals remain intact, while capacity expansion and margin expansion through higher value products from improved product mix, while our valuation re-ratings have allowed us to upgrade our call for SCIENTX, resulting in all Plastic Manufacturers under our coverage warranting an OUTPERFORM call on higher TPs; **SCIENTX (TP: RM15.13), SLP (TP: RM3.11),** and **TGUAN (TP: RM4.49).** While the sector has fared well over the last one year, the sector is re-rating given the changes in demand requirements for flexible packaging**.**

Risks to our calls include: (i) USD reversing against the Ringgit, compressing sales growth, (ii) slower-than-expected demand for plastic products, especially from importing countries, (iii) higher-than-expected resin prices, compressing margins and (iv) a sector de-rating due to weaker valuations from unfavourable macroeconomic situation.

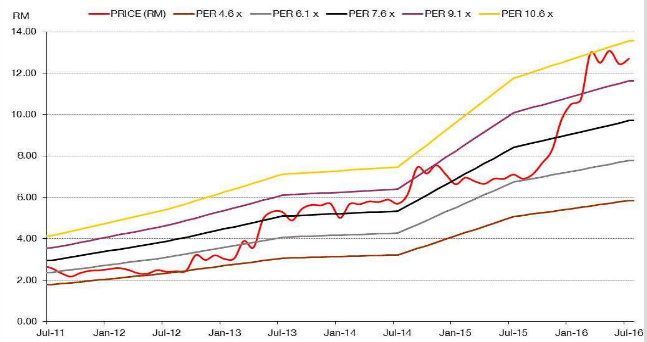
TPPA a longer term positive. A PricewaterhouseCoopers (PwC) study highlighted that the US currently has anti-dumping duties of 104% on Plastic Retail Carrier Bags, which comprise about one-third of Malaysia's production of downstream plastics. Hence, reduction/removal of the duty will benefit plastic players, including SLP and BP Plastics. They also pointed out that resin costs could also decline, because 37% of raw material comes from TPPA member countries (i.e. Singapore, Japan & US). Thus, we are optimistic that the TPPA will have a long-term positive impact on the Plastics and Packaging sector.

Peer Comparison

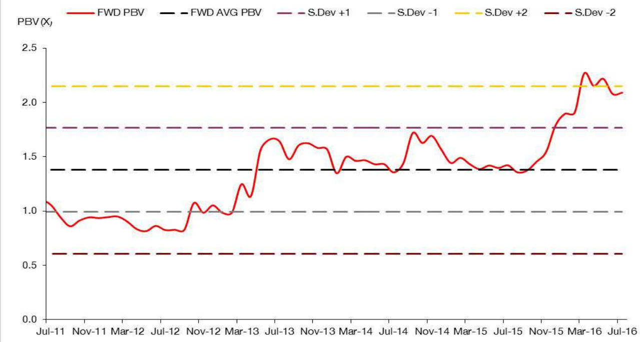
Company	Price (RM)	Mkt Cap (RM'm)	PER CY15	PER CY16	PER CY17	Est. Div. Yld.	His. ROE	His. P/BV	NP Growth (%) CY16	NP Growth (%) CY17	Target	Rating
Core Coverage												
SCIENTX	12.70	2,927.0	15.2	10.9	9.3	2.6	20.4	3.1	39.9	16.6	15.13	OUTPERFORM
SLP	2.72	672.7	25.9	22.9	18.8	1.7	22.8	5.9	13.2	21.6	3.11	OUTPERFORM
TGUAN	4.17	439.0	12.7	8.5	7.7	2.0	8.9	1.1	48.8	10.3	4.49	OUTPERFORM
Simple Average			**17.9**	**14.1**	**12.0**							
Weighted Average			**16.7**	**12.6**	**10.7**							
Non-Core Coverage												
DAIBOCI	2.11	574.5	21.4	16.7	13.8	6.4	14.8	3.2	28.1	20.8	NOT RATED	NOT RATED
SCGM	3.46	456.7	24.5	18.8	17.3	2.9	15.6	4.6	30.6	8.5	NOT RATED	NOT RATED
Simple Average			**23.0**	**17.7**	**15.6**							
Weighted Average			**22.8**	**17.6**	**15.4**							

Source: Kenanga Research

SCIENTX: Fwd PER Band

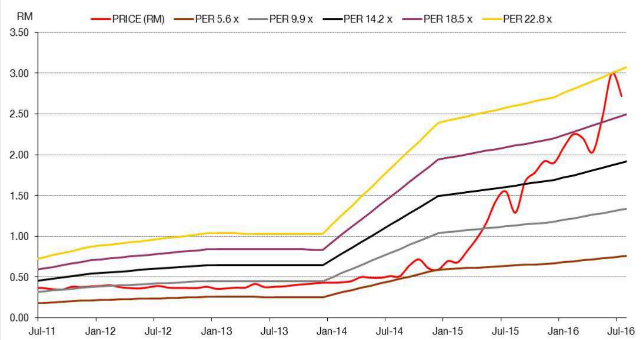


SCIENTX: Fwd PBV Band

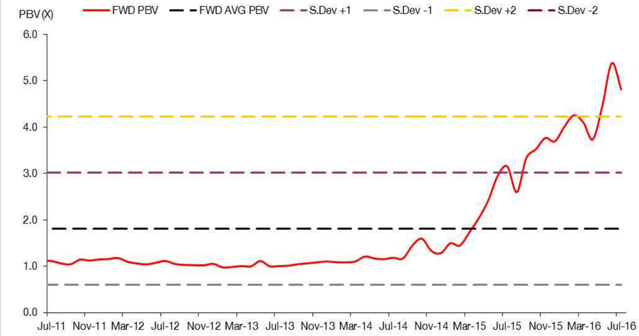


Source: Bloomberg, Kenanga Research

SLP: Fwd PER Band

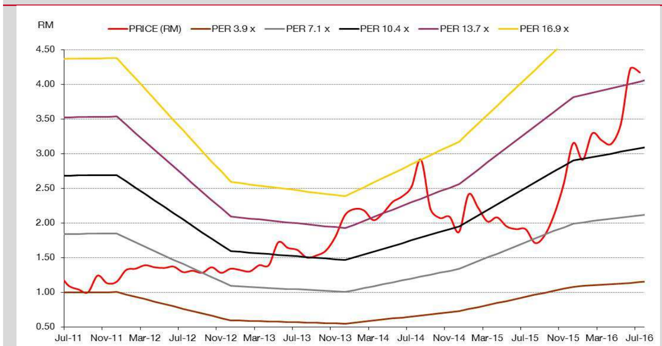


SLP: Fwd PBV Band

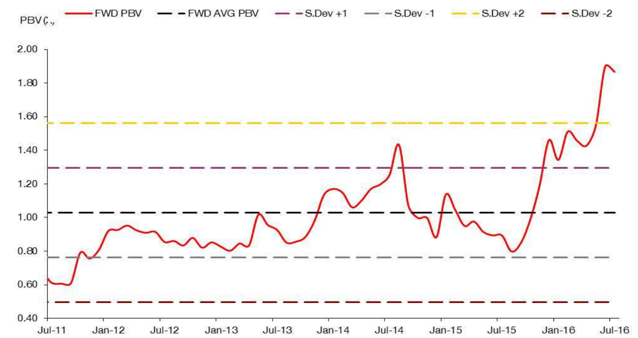


Source: Bloomberg, Kenanga Research

TGUAN: Fwd Core PER Band



TGUAN: Fwd PBV Band



Source: Bloomberg, Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10% (an approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%).
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of 3% to 10%.
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than 3% (an approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate).

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10% (an approximation to the 5-year annualised Total Return of FBMKLCI of 10.2%).
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of 3% to 10%.
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than 3% (an approximation to the 12-month Fixed Deposit Rate of 3.15% as a proxy to Risk-Free Rate).

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

Published and printed by:

KENANGA INVESTMENT BANK BERHAD (15678-H)
8th Floor, Kenanga International, Jalan Sultan Ismail, 50250 Kuala Lumpur, Malaysia
Telephone: (603) 2166 6822 Facsimile: (603) 2166 6823 Website: www.kenanga.com.my

Chan Ken Yew
Head of Research