

17 September 2004

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**Recommendation**

**BUY**

**Price**  
**RM3.88**

**12-mth target price**  
**RM4.64**

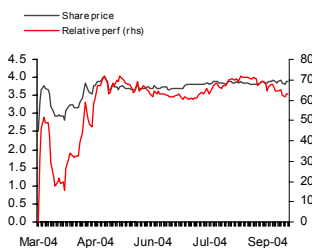
**Share cap / Market cap**  
60.0m / RM234.0m

**Free float**  
12.2%

**Major shareholders**  
Lin Tsai-Rong (28.1%)  
Tsai Chung-Wen (11.0%)  
Mendu SB. (8.7%)  
Forum Timber SB (8.3%)  
Hsu How-Tong (8.3%)  
Shell Stichting  
Pensioenfonds (5.83%)

**Consensus (Net profit)**  
04F : RM21.1m  
05F : RM23.4m

**Price performance chart**



# Cymao Holdings

## A Potent Mix

- Performed to Expectations since IPO with Strong 2Q results
- Overweight on Timber sector with Sustainable Demand and Short Supply of Plywood from Indonesia
- Cymao focusing on Developing Value-added products with Less Volatility in Demand and Higher Margins
- Conservatively managed with Strong Emphasis on Efficiency Improvement and Raw Material Supply management
- Compares favourably to Sarawakian big timber players despite the lack of a concession
- FY05 EPS estimate of 38.5 sen with Dividend yield expected to be a decent 3.2%
- Fair Value upgraded to RM4.64. With a 19.6% upside, we maintain our Buy recommendation

### Earnings Table

Year to 31 Dec	02A	03A	04F	05F	06F
Turnover (RMm)	139.6	155.5	197.8	206.0	209.4
EBITDA (RMm)	20.3	24.6	32.2	36.6	37.8
Pretax (RMm)	15.3	19.3	26.3	30.2	31.3
Net profit (RMm)	14.4	16.6	20.1	23.1	24.0
FD EPS (sen)	28.2	32.6	33.5	38.5	40.0
YoY change (%)	(2.1)	15.5	3.0	14.8	3.8
PER (x)	13.8	12.0	11.6	10.1	9.8
GDPS (sen)	-	-	10.0	12.5	12.5
Div yield (%)	-	-	2.6	3.2	3.2
ROE (%)	15.5	13.2	21.9	14.8	15.0
NTA PS (RM)	2.13	1.97	2.26	2.56	2.87
P/BV (x)	1.8	2.0	1.7	1.5	1.4

FD EPS for FY02-FY03 is based on 51m shares, for FY04 -06 60m shares.

**A Good Mix of Old and New**

Cymao Holdings, whose name means 'New Prosperity', has met our expectations by turning in excellent results since its listing in March and even announcing a higher interim dividend than the full year forecast. We caught up recently with the controlling Lin family to understand a little more on their management principles and future plans. The meeting left us impressed by their mixture of conservative 'Eastern' management principles coupled with a progressive 'Western' view of R&D and continuous improvement in operations.

**A Strong 2Q performance**

A quick look at Cymao's 2Q performance reveals that it was influenced by the rise in both plywood (its product) and log prices (its main raw material). While revenue grew by 64.9% q-o-q to RM60.9m, EBITDA only grew by 18.1% to RM8.7m. Nonetheless, Cymao still reported a 17% q-o-q growth in net earnings to RM5.4m. 1H04 net

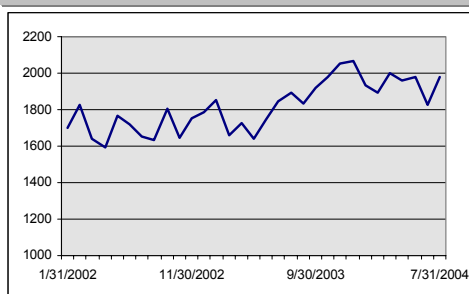
earnings reached RM10m, making its full year 2004 forecast of RM20.1m well within reach. In terms of its balance sheet, a net cash pile of RM13m with NTA/share at RM2.22 puts Cymao ahead of many other Sabah based timber companies. Given the sustained demand and tight supply of tropical timber products, we believe Cymao will be able to carve out its special niche among Malaysian timber companies as explored in the following sections.

## Demand from US and Japan sustainable

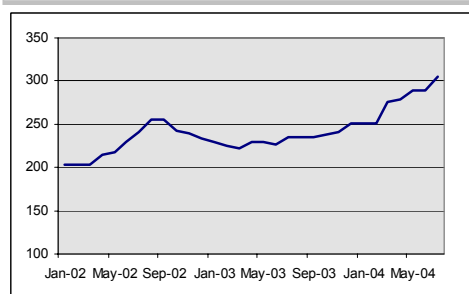
### Housing Starts Up

Given that Cymao's largely exports its plywood to the US, it is exposed to fluctuations in US housing starts which track the number of new houses being constructed in the US. For the past 3 years, US housing starts have been strong as interest rates in the US have been at historic lows. This has fuelled demand for plywood which is used in the construction industry. Nonetheless, prices for tropical plywood only started to rise significantly in the second half of 2003, when the recovering East Asian economy led to strong demand for plywood in Japan, South Korea and Taiwan. Although Cymao's exposure to these markets is limited, the effect of greater plywood demand among East Asian countries is to reduce the availability of tropical plywood from the general market. Therefore, Cymao will also enjoy **rising plywood prices**.

**Figure 1 : US Monthly Housing Starts ('000)**



**Figure 2 : Average Prices of Malaysian Tropical Plywood (USD/ cu m)**



Source: Bloomberg, ITTO

### Going Forward, Home Refurbishment and Transport Industry will be more Important

Looking forward, as US interest rates (Benchmark Federal Fund Rate) begin to return to normal levels with expectations that it will reach 2.25% to 2.5% by year end from its current level at 1.5%, we expect housing starts to moderate moving forward. This will dampen demand for conventional plywood to be used in the construction of new houses. However, as Cymao's plywood is also **used in the transportation industry for constructing truck bodies** as well as packaging, we foresee the selling price of their conventional plywood to remain stable for 2005 – 2006. Nonetheless, Cymao's decorative and specialty plywood which is largely used for interior purposes should continue to see strong demand as focus shifts from construction of new houses to **refurbishment of existing properties**. As such, we still forecast minimal increases in prices of decorative and specialty plywood going forward. Large consumers of Cymao's products include Home Depot, the world's largest home improvement retailer and Great Dane, the world's largest truck trailer manufacturing company.

### Europe will be Key for Cymao

With European consumers increasingly clamouring for more environmentally friendly products, the **demand for timber products certified as environmentally sustainable** will be strong moving forward. Given that a number of Cymao's products are certified under the Forest Stewardship Council (FSC), Cymao should find it easier to penetrate into the European market. Cymao informed us that they were the first plywood producer in South East Asia to be FSC certified. Cymao is also pursuing the EU CE certification that will allow it supply to government projects throughout the EU. We were informed that timber suppliers have until the end of this year to be CE certified or their products will no longer be used in government sponsored projects. As such, with its environmental credentials, we believe that Europe will be the next key market for Cymao.

### Other Specialty Products will also Play a Key Role

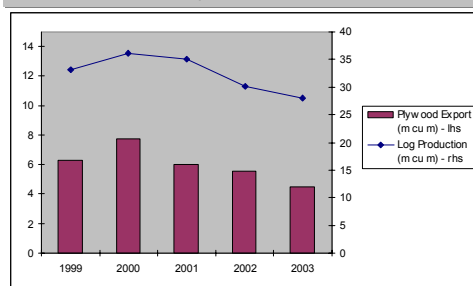
Cymao's products range includes specialty products such as Lay-on, wood instrument components and fire-retardent plywood. The margins for these products are high given their specialty nature and Cymao expects to focus more on these products moving forward. We take a closer look at Cymao's specialty products in the following sections.

### Supply: A Case of Managing Public Relations

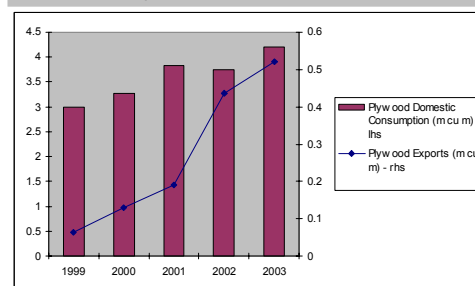
#### Indonesia cutting log quota

The Indonesian timber industry has received a lot of bad publicity in the past regarding the amount of timber extracted illegally. It has been estimated that in 2002, the ratio of total logs produced to the actual log quota was 2.5x. This prompted a number of NGOs to propose boycotts of Indonesian timber products and led to a ban on Indonesian round log exports in June 2002. In 2003, the government slashed log quotas from 12m cu m in 2002 to 6.98m cu m. **Efforts to further curtail illegal logging have continued this year** with log quotas further cut to just 5.74m cu m and the death penalty proposed for illegal logging. The effectiveness of the measures has contributed to the rise in timber prices and we believe these efforts will continue in the future with the log quota for 2005 proposed at 5.45m cu m. These will cause plywood producers in Indonesia to face difficulties in securing raw materials and we estimate that prices will be sustained despite a moderation in global economic growth.

**Figure 3 : Indonesian log and plywood supply**



**Figure 4 : China's consumption of plywood and exports**



Source: ITTO

### The Beijing Olympics will Reduce Plywood Supply from China

In recent years, China has built up its domestic plywood industry with import duties on plywood and aggressively buying tropical and softwood logs. At the same time, its consumption of tropical plywood has also grown by a CAGR of 8.9% since 1999. It has also started to export its plywood with 0.52m cu m exported in 2003. However, the plywood from China tends to be of lower quality and manufactured as a small enterprise industry with separate enterprises carrying out the treatment, cutting and laminating. As such, China was increasingly seen as a direct competitor to tropical plywood exporters for the lower end of the market. Nonetheless, with the 2008 Beijing Olympics coming up, China needs to invest in sporting facilities, infrastructure and tourism facilities in order to be able to meet the standards set at the recent Athens Olympics. The International Tropical Timber Organisation (ITTO) recently published that China needs:

- 70,000 sq m of wooden floors and 50,000 wooden doors for its sporting facilities
- 190,000 sq m of wooden floors and 6,200 wooden doors for its hospitals
- 5m sq m and 31,000 wooden doors for its hotels

in its preparation for the Beijing Olympics. This does not include furnishing and other interior requirements. As such, we feel that timber consumption from China will be very strong starting in 2006 in its run-up to the Olympics. Its **exports of plywood will dwindle given its domestic demand** and plywood from China will no longer flood the lower end of the plywood market.

## Cymao's Strengths in High-End Products, R&D & Efficient Management

### Higher End Products Command Better Margins

We believe that the factors above highlight that sustained demand and tight supply will augur well for the timber industry moving forward. However, the question then remains: What is Cymao's advantage?

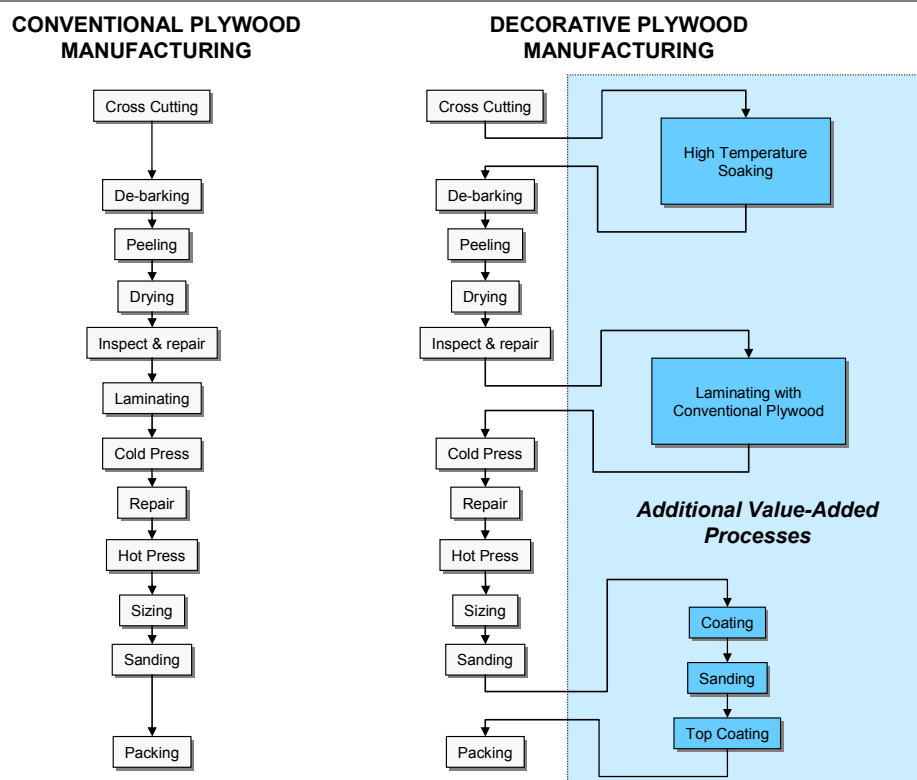
### *The answer lies in its product range and management expertise*

To recap, Cymao's main products include:

- Conventional plywood
- Decorative plywood which involves a layer of temperate log veneer over conventional plywood
- Lay-on which is a thin layer of high quality veneer that can be ironed on other timber products
- Engineered wood flooring which is high quality plywood used for flooring purposes
- Wooden Instrument components where high quality plywood is used to make drums and other instruments

As such, its product range includes a number of specialty products and reflects the effort by the company in developing new niche products that will command a better premium and be more resistant to price swings. The figure below details the additional effort required to manufacture decorative plywood as compared to conventional plywood. This extra effort means that out of the 68 plywood manufacturers in Sabah, only 8 manufacture decorative plywood, making it a far more lucrative product to sell.

**Figure 5 : Comparison between the Manufacture of Conventional and Decorative Plywood**



Source: Company Data, OSK Research

### R&D Into New Products

With Lin Kai-Hsuan, the Executive Director for Cymao in charge of Operations, having a Bachelor of Science in Applied Mathematics and a minor in Economics as well as a Master of Science in Forest Science, it is no surprise that Cymao has a slant towards Research into new and innovative products. Among these products are:

- Marine plywood where the use of marine grade glue allows the use of plywood on various marine craft

- Polyester plywood where a layer of polyester is applied to the top of plywood to make it scratch resistant
- Fire-retardent plywood, likely the first of its kind, where chemicals impregnated into the plywood make it fire resistant and therefore a lighter substitute for the solid wood doors currently used as fire exit doors

These products, when properly launched will provide Cymao with higher margins. We have nonetheless conservatively discounted the impact of these products in our forecasts.

#### Focus on Efficiency

The final selling point for Cymao is its unceasing efforts to improve margins and increase efficiency. Among its efforts in this direction are:

- The purchase of new peeler machines that can peel to smaller log cores which will increase the recovery rate of logs from 55% to 60%
- Revamping processes to establish a chain of responsibility among labour to promote productivity along the lines of the 'Six-Sigma' system

Aside from these efforts, Cymao is also looking into using oil palm logs to reduce costs and ensure a stable log supply as well as investigating the viability of securing a permanent supply of logs in Sabah.

#### Main Risk is Still the Lack of a Concession

#### Mitigated through Contracts and Raw Material Flexibility

Cymao's lack of a timber concession remains our main source of concern. However, the company has mitigated this risk through various means. Firstly if there is a ready and cheap source of plywood, Cymao will purchase the plywood for the manufacture of their decorative plywood and other specialty products. This is because the premium commanded by these products allow them to absorb the higher price of the conventional plywood as compared to manufacturing plywood straight from logs. As such, even if logs are in short supply, Cymao is able to produce decorative and specialty plywood. Secondly, Cymao has entered into long term contracts for the supply of logs as highlighted below:

**Figure 6 : Cymao's Raw Material Long Term Contracts**

Supplying	Organisation	Min. Annual Volume (cu m)	Period of Agreement
Tropical Veneer & Plywood	Country-Forests Industries SB	30,000	Perpetual
Tropical Veneer & Plywood	Sabah Forest Industries SB	17,000	Perpetual
Tropical Logs	Sapulut Forest Development SB	30,000 - 70,000	10 years
Tropical Logs	Syarikat Hung Enterprise	40,000 - 60,000	10 years
Temperate Logs	Gaintrad Ltd., Taiwan	1,000	Perpetual
Temperate Logs & Veneer	Woodleader Enterprise Co Ltd, Taiwan	1,500	Perpetual
Temperate Logs	China Timber Import & Export Corporation, China	1,000	Perpetual

Source: Company Data, OSK Research

Based on the factors discussed, our long term outlook for Cymao is:

- Production utilisation to increase moderately moving forward
- Prices of conventional plywood to stabilise in 2005 and flatten out
- Prices of decorative and specialty plywood to rise minimally moving forward
- Raw material costs to stabilise in 2005
- Moderate capex largely focused on efficiency improvement once new mill is set up in 2005
- Still enjoying lower tax rate due to pioneer status on specialty plywood products.

Our main assumptions are detailed as follows:

**Figure 7 : Key Forecasts for Cymao**

Assumptions	2003	2004e	2005e
Conventional Plywood Production (cu m)	98,601	103,950	105,050
Conventional Plywood Prices (USD/cu m)	266.09	306.01	312.13
Recovery Rate from Logs	56%	56%	57%
Cost of Raw Material Logs (RM/cu m)	320.00	371.20	382.34
Decorative Plywood Production (cu m)	23,698	29,100	29,550
Decorative Plywood Prices (USD/cu m)	505.26	545.68	564.78
Recovery Rate from Logs	60%	60%	61%
Cost of Raw Material Logs (RM/cu m) Temperate & Tropical	653.02	705.26	719.36
Specialty Plywood Production (cu m) Total	6,004	7,700	8,050
Specialty Plywood Prices (USD/cu m) Average	449.97	567.20	589.17
Depreciation Charges (RMm)	5.3	5.9	6.4
Tax rate	14.1%	23.5%	23.5%

e - Estimates

### Valuation

#### Fair Value Upgraded

We had previously applied a 30% discount to Cymao's fair value given its IPO status and the lack of a concession. Given that the company has performed credibly since its IPO, we accordingly reduce the discount applied to 10%. Applying the discount to our timber sector PER of 13.4x and Cymao's FY05 EPS of 38.5 sen, our fair value is upgraded to RM4.64. This gives an upside of 19.6% and we **maintain our Buy** call. In addition, Cymao has declared an interim tax-exempt dividend of 7.5 sen which exceeds their IPO forecast for full year tax-exempt dividend of 5 sen.

Comparing Cymao to the Sarawak large timber players reveals that it is more than able to stand up against these players despite not having its own concession. As such, Cymao remains one of our top timber sector picks.

**Figure 8 : Comparison with Sarawakian Timber Players**

	Jaya Tiasa	Subur Tiasa	WTK	Ta Ann	Cymao
Price (16 September 04)	4.00	2.53	5.50	6.85	3.88
Projected EPS (sen)	28.1	20.3	50.2	57.8	34.7
Projected PER	14.2	12.4	11.0	11.9	11.2
Latest NTA (RM)	2.76	1.90	4.47	2.32	2.27
P/BV	1.45	1.33	1.23	2.95	1.71
Historical Div Yield (%)	1.25	1.98	1.45	2.92	1.93

PER projection for current FY – FY04 for WTK, Ta Ann and Cymao, FY05 for Jaya Tiasa and annualised FY05 for Subur Tiasa

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