

Corporate Highlights

Sector Update

Timber

Japan Housing Starts Fell In February



RHB Research Institute Sdn Bhd
A member of the RHB Banking Group
Company No: 233327 -M

5 April 2010

Recom : **Neutral**
(Maintained)

Table 1 : Timber Sector Valuations

	FYE	Price (RM/s)	Fair Value (RM/s)	EPS (sen)		EPS growth (%)		PER (x)		P/NTA (x)	P/CF (x)	GDY (%)	Rec
				FY10	FY11	FY10	FY11	FY10	FY11	FY10	FY10	FY10	
Ta Ann	Dec	6.10	7.60	54.1	65.7	90.0	21.2	11.3	9.3	1.8	7.7	1.1	OP
Evergreen	Dec	1.76	2.35	21.3	23.3	26.1	9.4	8.3	7.5	1.2	11.6	2.8	OP
WTKH	Dec	1.37	1.55	11.1	14.6	+>100	32.0	12.4	9.4	0.8	n.m	4.4	OP
Jaya Tiasa^	Apr	3.73	3.05	27.7	55.5	+>100	+>100	13.5	6.7	0.9	9.2	0.0	UP
Sector Avg						101.5	36.6	11.0	8.0				

^ FY10-11 valuations refer to those of FY11-FY12

◆ **Japan housing starts fell in February.** Contrary to expectations, Japan housing starts have recorded a 15th straight month of decline, with the latest Feb 10 figure standing at 56,527 units, a drop of 9.3% yoy and 13.0% mom from Jan 10, which was below economists' expectations of a 1% drop yoy.

◆ **Renovation instead?** The Japan government is encouraging its people to renovate their homes as a step toward creating a stronger resale market instead of rebuilding them. The government is also offering environmental incentives to homeowners to renovate instead of the "postwar scrap-and-build policy" of tearing down old houses. While we identify potential beneficiaries from this programme to be WTK and Ta Ann (which produces floorbase plywood used in renovation works), we highlight that this positive effect would be offset by the decrease in construction of new housing, which would reduce the demand for basic plywood products.

◆ **Prices and volumes firming up for plywood...** Upward price trend confirmed by official figures from Japan Lumber and a further price appreciation is expected in 2Q10 due to supply shortages. We expect prices to increase by 10-15% in CY10 (for Jaya Tiasa, FY04/11). As for plywood volumes, we expect an increase in production volumes by 17-30% due to gradual recovery in plywood demand and supply shortages.

◆ **... While volumes for logs may be affected.** We understand that Sarawak's tropical log exports have fallen following the current dry spell. Two timber players who would be most affected by this are Jaya Tiasa and WTK. However, we expect this impact to be temporary as seasonally, the dry period should recover by Mar / Apr 10. We expect the drop in logs volumes to be offset by a recovery in selling prices of 5-10% from the low last year. We currently forecast log volumes to rise by 5-10% in CY10 (for Jaya Tiasa, FY04/11) and log prices to increase by 10% yoy in CY10 (for Jaya Tiasa, FY04/11).

◆ **Forecasts.** We maintained our earnings forecasts for now.

◆ **Risks:** 1) Timber demand improving significantly, resulting in higher-than-expected timber prices; 2) A sharper-than-expected recovery in Japan's economy; 3) Reduced competition from other major plywood exporting countries (i.e. Indonesia and China) due to plant closure etc.; and 4) Significant reductions in glue and logistics costs.

◆ **Maintain Neutral, top picks are Ta Ann and Evergreen.** We are maintaining our Neutral call on the timber sector as there could still be a risk of another false start to the economic recovery in Japan. Our top picks are Ta Ann (OP; FV = RM7.60) and Evergreen (OP; FV = RM2.35). We also have an Outperform recommendation on WTK (OP; FV = RM1.55) and an Underperform recommendation on Jaya Tiasa (UP; FV = RM3.05).

Chart 1. Japan Total Log Imports

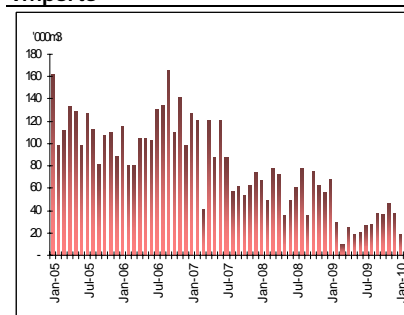
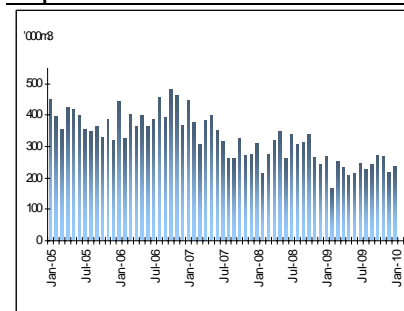
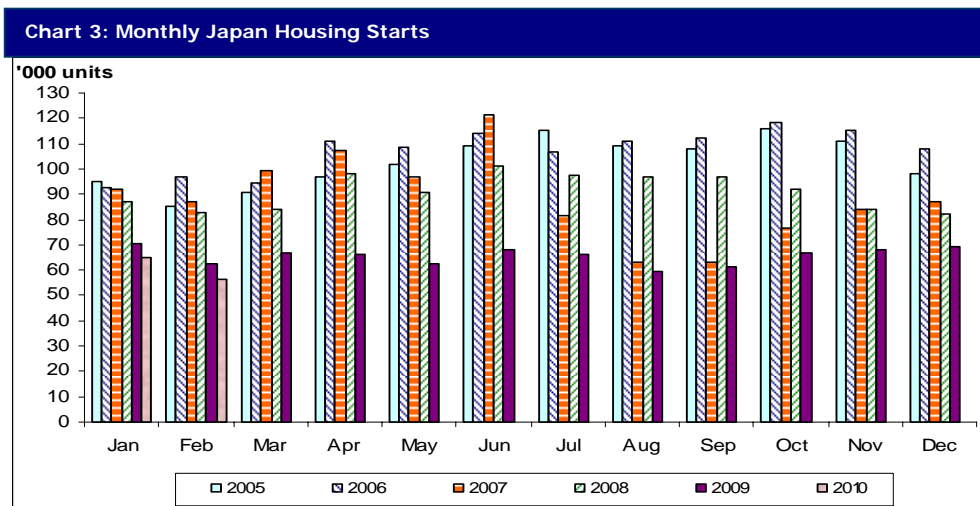


Chart 2 Japan Total Plywood Imports



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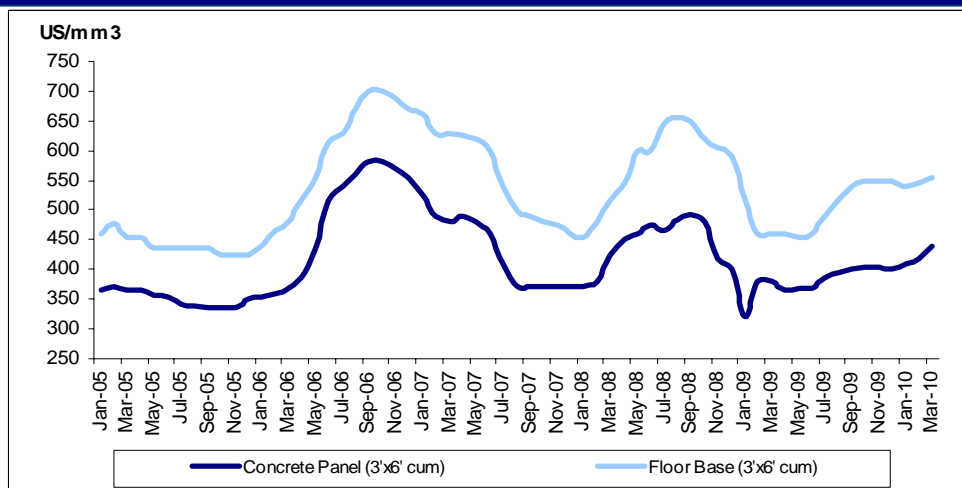
- ◆ **Japan housing starts fell in February.** Contrary to expectations, Japan housing starts have recorded a 15th straight month of decline, with the latest Feb 10 figure standing at 56,527 units, a drop of 9.3% yoy and 13.0% mom from Jan 10, which was below economists' expectations of a 1% drop yoy (see Chart 3). Meanwhile, the value of construction orders received by the big 50 contractors failed to continue its two month upward trend, slipping by 20.3% yoy in Feb 2010 from a 15.7% yoy rise in Jan 10.
- ◆ **Renovation instead?** The Japan government is encouraging its people to renovate their homes as a step toward creating a stronger resale market instead of rebuilding them. The government is also offering environmental incentives to homeowners to renovate instead of the "postwar scrap-and-build policy" of tearing down old houses. Currently, Japanese houses have an average lifespan of 20-30 years vs. 55 years in the US. The government has also recently started an eco-point incentive scheme which encourages people to build environmentally friendly new houses. How this works is that during the period of 1 Jan to 31 Dec 10, for any purchase of energy-efficient housing products, applicants of this scheme can receive up to 300,000 points with each point worth JPY1, which can be translated to purchase other types of housing materials or donated to conservation groups. While we identify potential beneficiaries from this programme to be WTK and Ta Ann (which produce floorbase plywood used in renovation works), we highlight that this positive effect would be offset by the decrease in construction of new housing, which would reduce the demand for basic plywood products.



Source: Japan Lumber Report, RHBRI

- ◆ **Prices and volumes firming up for plywood.** We have assumed an increase in plywood prices by 10-15% yoy in CY10 (for Jaya Tiasa, FY04/11), which was adjusted up (from 5-7%) in our recent 2Q2010 timber sector strategy piece following the upward price trend confirmed by official figures from Japan Lumber and a further price appreciation expected in 2Q10 due to supply shortages. As for plywood volumes, we have projected an increase in production volumes of unchanged 17-30% (Jaya Tiasa being 30% due to its low base effect) in CY10 (for Jaya Tiasa, FY04/11). This is despite the lower imported figures of Malaysian plywood to Japan (-16% yoy) in Jan 10, which we believe was mainly attributable to Shin Yang's shifting of market focus away from Japan. YTD, Ta Ann's plywood volume orders have increased by more than 12% vs. 2009 average volumes, which is within our expectations. As such, we are maintaining our plywood volumes for the timber players.

Chart 4: Tropical Plywood Price Trend



Source: Japan Lumber Report, RHBRI

- ◆ **Logs – slight increase in average selling prices but volumes may be affected.** We understand that Sarawak's tropical log exports have fallen following the current dry spell, which have caused water levels in rivers to drop, making it difficult to transport the logs out of the forest concession. We believe the two timber concession who would be most affected by this are Jaya Tiasa and WTK. Nevertheless, we expect this impact to be temporary as seasonally, the dry period should end by Mar / Apr 10 and log volumes should then start to recover from 2Q10. We expect the drop in log volumes to be offset by a recovery in selling prices of between 5-10% from the low last year due to the tighter supply. We currently forecast log volumes to rise by 5-10% in CY10 (for Jaya Tiasa, FY04/11) and log prices to increase by 10% yoy in CY10 (for Jaya Tiasa, FY04/11).
- ◆ **Royalty rates to increase again?** *The Star* recently reported that the Sarawak State Government (SSG) has rejected Sarawak Timber Association (STA)'s request for a 50% discount on royalty for timber extracted from agro-conversion areas as well as for timber with a diameter size of 30cm to 40cm. However, the SSG has accepted the appeal of STA to defer the increase in timber royalty rates by 6 months until Jun 10. What this implies is that timber companies will continue to pay the old royalty of RM50/m³ instead of RM55/m³ as fixed by authorities. Recall that under a revision of the royalty rates two years ago, the Sarawak Forestry Department (SFD) has proposed a flat rate of RM65/m³ for all timber with a diameter of 30 cm and above. However, STA argued that the proposed flat rate was "inequitable" and it was changed to RM50/m³ last year then revised to RM55/m³ this year and RM60/m³ next year. On planted forest, the association was awaiting the SFD's reply to its request for exemption from the payment of cess for 5 years, starting from the first harvest of a plantation. We believe that the deferment of the increase in timber royalty rates by until Jun 10 implies that fundamentals for the timber sector has yet to fully recover (as evident by the poor Japan housing starts and low average selling prices for logs and plywood products) and that timber players are still needing some help from the SSG to buffer its earnings. We are overall neutral to slightly positive on this development as it shows some support from the SSG to help timber players during times of crisis but in the near term, any royalty rate increase would still impact timber players under our coverage. We maintain our forecasts for the royalty rates for now, pending further details from timber players.

Risks

- ◆ **Upside risk.** The risks include: 1) timber demand improving significantly, resulting in higher-than-expected timber prices; 2) a sharper-than-expected recovery in Japan's economy; 3) reduced competition from other major plywood exporting countries (i.e. Indonesia and China) due to plant closure etc.; and 4) significant reductions in glue and logistics costs.
- ◆ **Downside risk.** The risks include: 1) longer-than-expected recovery for the timber sector; and 2) price discounting from neighbouring countries with lower cost of production, resulting in lower exports from Malaysia to its major export markets.

Forecasts

- ◆ **No changes to earnings forecasts.** We maintain our earnings forecasts for now.

Valuations and recommendation

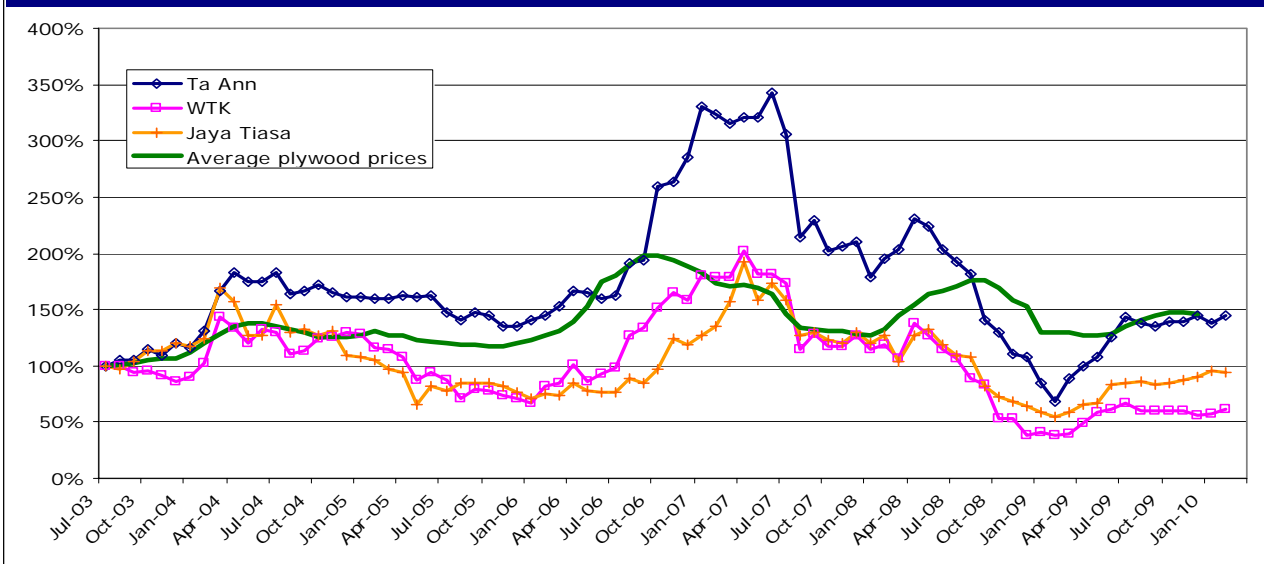
- ◆ **We are maintaining our Neutral call** on the timber sector as there could still be a risk of another false start to the economic recovery in Japan as has happened several times since 1990s and the risk relating to slower demand recovery coming from still weak Japan housing start numbers.
- ◆ **Top picks are Ta Ann and Evergreen.** Our top picks are Ta Ann (OP; FV = RM7.60) and Evergreen (OP; FV = RM2.35). For Ta Ann, earnings would be driven mainly by its plantation division while any further upside to the plywood division would further boost its earnings. For Evergreen, structural changes in the industry i.e. gradual increase in real demand and supply shortages from the closure of plants will be major boosters to capacity utilisation and average selling prices and thus, earnings for the group. We also have an Outperform recommendation on WTK (OP; FV = RM1.55) and an Underperform recommendation on Jaya Tiasa (UP; FV = RM3.05).

Table 2. Valuation Bases

Company	Fair Value (RM/share)	Valuation Methodology	Recommendation
Ta Ann	7.60	Target PER of 14x CY10 earnings for the timber division and 14x CY10 earnings for the plantation division	OP
WTKH	1.55	Target PER of 14x CY10 earnings	OP
JTiasa	3.05	Target PER of 14x CY10 earnings for the timber division and 14x CY10 earnings for the plantation division	UP
Evergreen	2.35	Target PER of 11x CY10 earnings	OP

- ◆ **Share price correlation with plywood prices highest for Ta Ann.** We have plotted the correlation between average plywood prices and share prices of timber players (i.e. Ta Ann, WTK and Jaya Tiasa) for the past 6 years (from Jul 03-Dec 09). From a graphical perspective, we believe that Ta Ann's share price generally outperforms on the upside when plywood prices are rising, and in line with the market when plywood prices are on the downtrend (see Chart 5). Meanwhile, for both WTK and Jaya Tiasa, their share prices generally perform in line with plywood prices, except when plywood prices are on a downtrend, which would see their share prices generally underperform. From a statistical perspective, we conclude that on average, Ta Ann has the highest share price correlation with plywood prices (about 62%); as compared to WTK (about 44%) and Jaya Tiasa (about 15%).

Chart 5: Correlation Between Average Plywood Prices And Share Prices Of Timber Players



Source: Japan Lumber Report, Bloomberg, RHBRI

Chart 6: Lingui Technical View Point



- ◆ After losing the crucial support level of RM1.33 in Jul 2008, the share price of Lingui has been trading under strong selling pressure.
- ◆ It attempted to reclaim the RM1.33 level in Jun 2009, but a failure forced it to retreat to the RM1.00 support region.
- ◆ But, on its second attempt in Mar 2010, the stock managed to pierce through the RM1.33 great resistance level.
- ◆ Technically, as it recently registered some consolidation patterns, its medium-term breakout pattern is still intact as long as it sustains at above RM1.33.
- ◆ In fact, it could resume its rally towards RM1.60 and RM1.90 after it has done with the consolidation at above RM1.33, in our view.

Chart 7: WTK Technical View Point



- ◆ WTK lost an important support level of RM2.08 in Jul 2008, and since then, it has been trading under great selling pressure.
- ◆ It tried to rebound in Apr 2009, but met with a high resistance at RM1.53 in Jun, before staggering around RM1.09 to RM1.34 range for most of the time since then.
- ◆ However, in late Mar 2010, as it staged another rally, it has penetrated the RM1.34 key resistance level on sustained buying supports.
- ◆ Technically, although it engages some profit-taking activities of late, the key breakout pattern remains intact.
- ◆ This means if the stock manages to sustain at above RM1.34, it could retest Jun 2009’s high of RM1.53 soon, before challenging RM1.71 and the crucial resistance level of RM2.08 on follow-through buying momentum.

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Trading Buy = Short-term positive development on the stock that could lead to a re-rating in the share price and translate into an absolute return of 15% or more over a period of three months, but fundamentals are not strong enough to warrant an Outperform call. It is generally for investors who are willing to take on higher risks.

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Neutral = Industry expected to perform in line with the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Underweight = Industry expected to underperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

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