

## UMW Holdings Berhad

(4588 | UMWH MK) Main | Consumer Products & Services

### Notes from UMW Aerospace Plant Visit

#### KEY INVESTMENT HIGHLIGHTS

- **UMW Aerospace reaching an earnings inflexion point**
- **Potential margin expansion from component localization**
- **Acquisition of electro-chemical milling capability opens doors for new opportunities**
- **Maintain BUY at unchanged TP of RM5.28**

*We came back from UMW Aerospace plant visit yesterday feeling broadly positive on the division's prospects. Below are key takeaways from the visit:*

**Quick background.** UMW Aerospace (UMWA) was inducted in the UMW group in 2015. It produces aircraft engine fan cases for Rolls Royce (RR) for the Trent 7000 (used exclusively for the A330 NEO) and Trent 1000 engines (30% of Boeing's B787 Dreamliner's engines are sourced from RR with the rest from GE). These are under a 25+5 year contract (signed in 2015) with UMWA being RR's single source-supplier for both the engines' fan cases. UMWA delivered its 1<sup>st</sup> Trent 1000 fan case in 2017 and saw its maiden profit in 2021, while, production of the Trent 7000 fan cases started in 2020.

**Defensive margins.** The production facility is divided into four main cells: (1) Front case machining (2) Inner ring machining (3) Welding (4) Assembly. The entire process of producing a fan case takes around 29-30 days before the finished fan cases are shipped to RR's UK facility for final engine assembly. Some RM750m was initially invested in the current plant. The main raw material used in the production of fan case components is titanium - fluctuation in raw material prices are ultimately passed through to the customer under the supply contract arrangement. In terms of forex exposure, UMWA attains a natural hedge as both raw material cost and revenue are denominated in USD. The plant also employs solar panels which cover up to 75% of the plant's energy needs and reduce cost by up to 27%.

**Utilisation rate improving.** While not at liberty to share specific details, UMWA indicated that plant utilisation rate has been improving in line with recovering aircraft orders globally. Losses has narrowed from -RM34m pretax loss in FY21 to -RM9m pretax loss in FY22, and UMWA is on track to register profits this year. We gather that UMWA has started breaking even in 4Q22 with further improvement in profitability in 1Q23. Based on RR's rolling 3-year plan, UMWA expects to fully utilise its capacity by 2026-27.

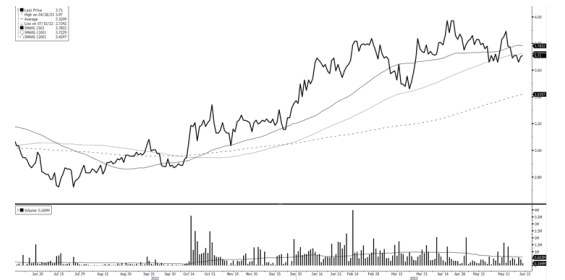
**Maintain BUY**

**Unchanged Target Price: RM5.28**

#### RETURN STATISTICS

Price @ 14 <sup>th</sup> June 2023 (RM)	3.71
Expected share price return (%)	+42.2
Expected dividend yield (%)	4.1
<b>Expected total return (%)</b>	<b>+46.3</b>

#### SHARE PRICE CHART



Price performance (%)	Absolute	Relative
1 month	3.8	4.2
3 months	-0.8	10.5
12 months	14.0	28.1

#### INVESTMENT STATISTICS

FYE Dec (RMm)	2022A	2023F	2024F
Revenue	15,814.4	15,316.3	15,523.2
Operating Profit	605.5	578.0	569.4
Profit Before Tax	896.5	858.6	848.3
Core PATAMI	415.0	447.5	443.8
Core EPS (sen)	35.5	38.3	38.0
DPS (sen)	14.2	15.3	15.2
Dividend Yield (%)	3.8	4.1	4.1

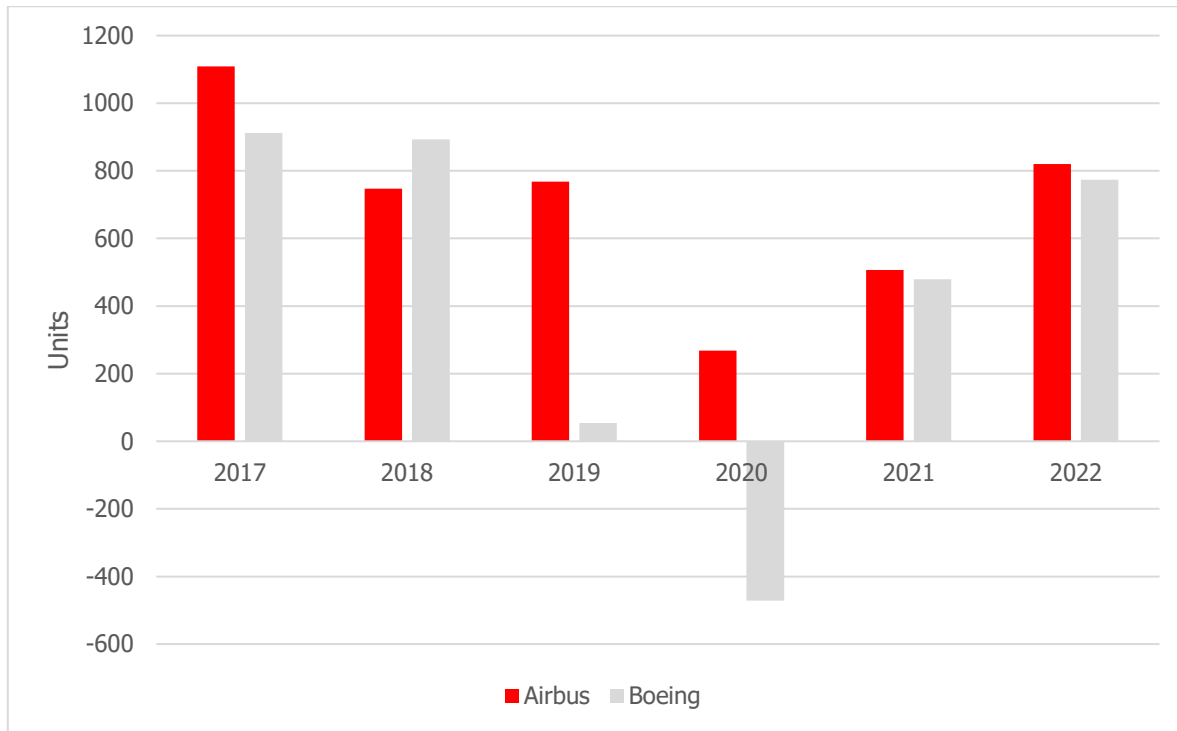
#### KEY STATISTICS

FBM KLCI	1,385.42
Issue shares (m)	1168.29
Estimated free float (%)	29.88
Market Capitalisation (RM'm)	4,275.96
52-wk price range	RM2.77-RM4.04
3-mth average daily volume (m)	0.69
3-mth average daily value (RM'm)	2.60
Top Shareholders (%)	
Amanah Saham Nasional Bhd	55.16
Kumpulan Wang Persaraan	9.26
Employees Provident Fund Board	9.18

**Analyst**

Hafriz Hezry  
hafriz.hezry@midf.com.my  
03-2173 8392

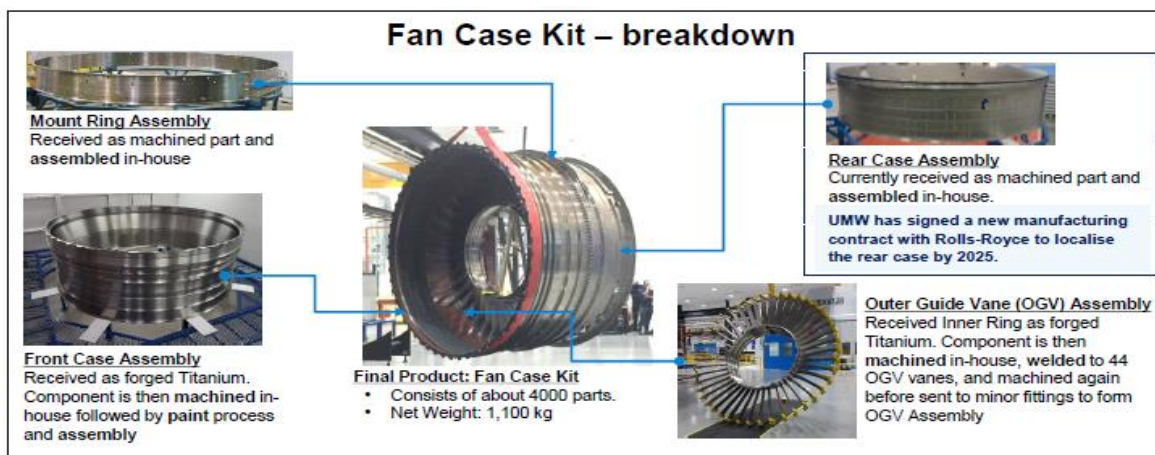
**Chart 1: Swift Rebound in (Net) Aircraft Orders at Airbus and Boeing**



Source: Company, MIDFR

**New rear case contract.** Management shared that UMW Aerospace’s (UMWA) new rear fan case manufacturing plant is expected to commence commercial operations in 2025. To recap, the new plant involves a capex of RM65m (mainly to acquire chemical milling capabilities) while the supply contract (for both Trent 1000 and 7000 engine rear cases) is valued at RM1b over a 15-year period. At present, the rear fan case is imported from the US and assembled into a complete fan - localisation of the rear fan case is expected to improve UMWA margins from FY25F onwards. The rear fan case volumes are expected to mirror supply volumes of the overall fan case as it forms part and parcel of the entire fan case module. The expansion into rear fan case manufacturing underpins earnings momentum beyond the current aviation cyclical recovery, in our opinion.

**Exhibit 1: Fan case kit breakdown**



Source: Company, MIDFR

**Chemical milling capabilities.** Importantly, manufacturing of rear fan cases involves the development of electro chemical milling capability which is lacking in ASEAN, whereas within Asia, is dominated by South Korea’s LAKWOO Industry Co. Ltd and China’s SinoGuide. UMWA will be the first ASEAN aero manufacturer to have this capability, which is expected to be a game changer for UMWA and could open up opportunities for manufacturing of other precision aero components such as jet engine after burners and aircraft wing skin panels; jet engine components are currently produced by in-house by RR. UMWA’s chemical milling capability is an in-house developed, proprietary process. Given that it is both technology and capital intensive, we believe this creates a reasonably high barrier to entry for competitors. We also understand that both the existing and new chemical milling plants are not exclusively for RR and allows UMWA to produce components for other OEMs, should the opportunity arise.

**Exhibit 2: Chemical Milling Gives UMWA a Unique Competitive Edge**

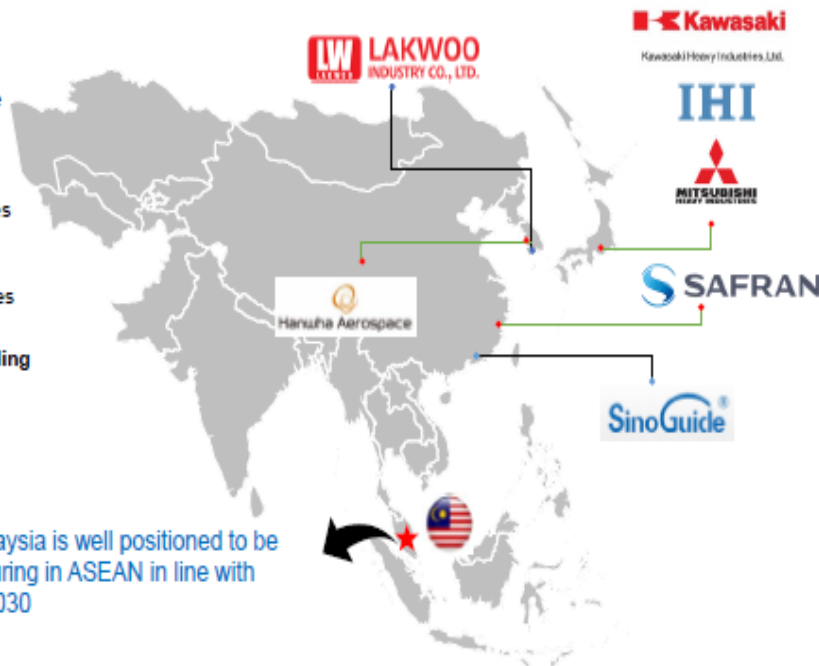
1. Market assessment on Tier 1 Complex Machining suppliers show real gap in the market for Chemical Milling capabilities
2. Many suppliers focus only on Machining, having both capabilities will be a key differentiator

**Aerospace Engine Component Suppliers – Complex Machining**

1. South Korea – Hanwha Aerospace
2. China - Safran Aircraft Engines Suzhou
3. Japan – Kawasaki Heavy Industries
4. Japan – IHI
5. Japan – Mitsubishi Heavy Industries

**Aerospace Industry – Chemical Milling**

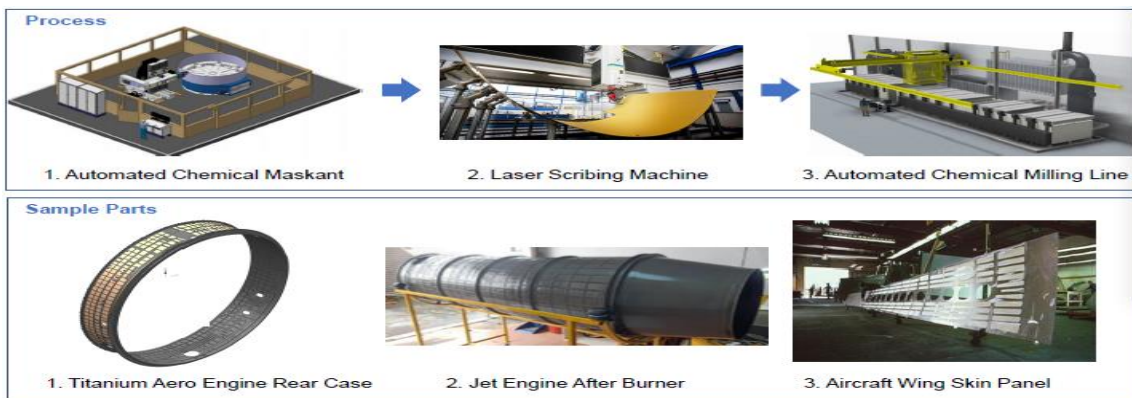
1. South Korea – LAKWOO
2. China – SinoGuide



With combined capabilities, Malaysia is well positioned to be the hub of Aero Parts Manufacturing in ASEAN in line with Malaysia Aerospace Blueprint 2030

Source: Company, MIDFR

**Exhibit 3: Chemical Milling Process (Top) and Parts (Bottom)**



Source: Company, MIDFR

**Well positioned to ride on Malaysia’s aerospace ambitions.** The Malaysian Aerospace Industry Blueprint was launched in 2015, envisioning Malaysia as the No. 1 aerospace nation in ASEAN by 2030. There are 4 focus areas of the blueprint namely: (1) Maintenance, Repair and Overhaul (2) Aero manufacturing (3) System integration (4) Engineering and design service. For aero manufacturing (which is where UMWA is positioned currently), Malaysia aims to be the No. 1 player in South East Asia for aero parts sourcing encompassing components within aero structures, avionic equipment, engine and airframe equipment. Globally, the aero engine market is worth USD38b (2018) and is projected to grow to USD211b by 2030. In Malaysia, the broader aerospace industry was valued at RM16.2b (RM8.8b export) in 2019 employing some 25,000 highly skilled workers, with an ambitious revenue target of RM55b by 2030.

**Exhibit 4: Global aero engine tiering**



\*from Rolls Royce annual report for commercial turbofan

Source: Company, MIDFR

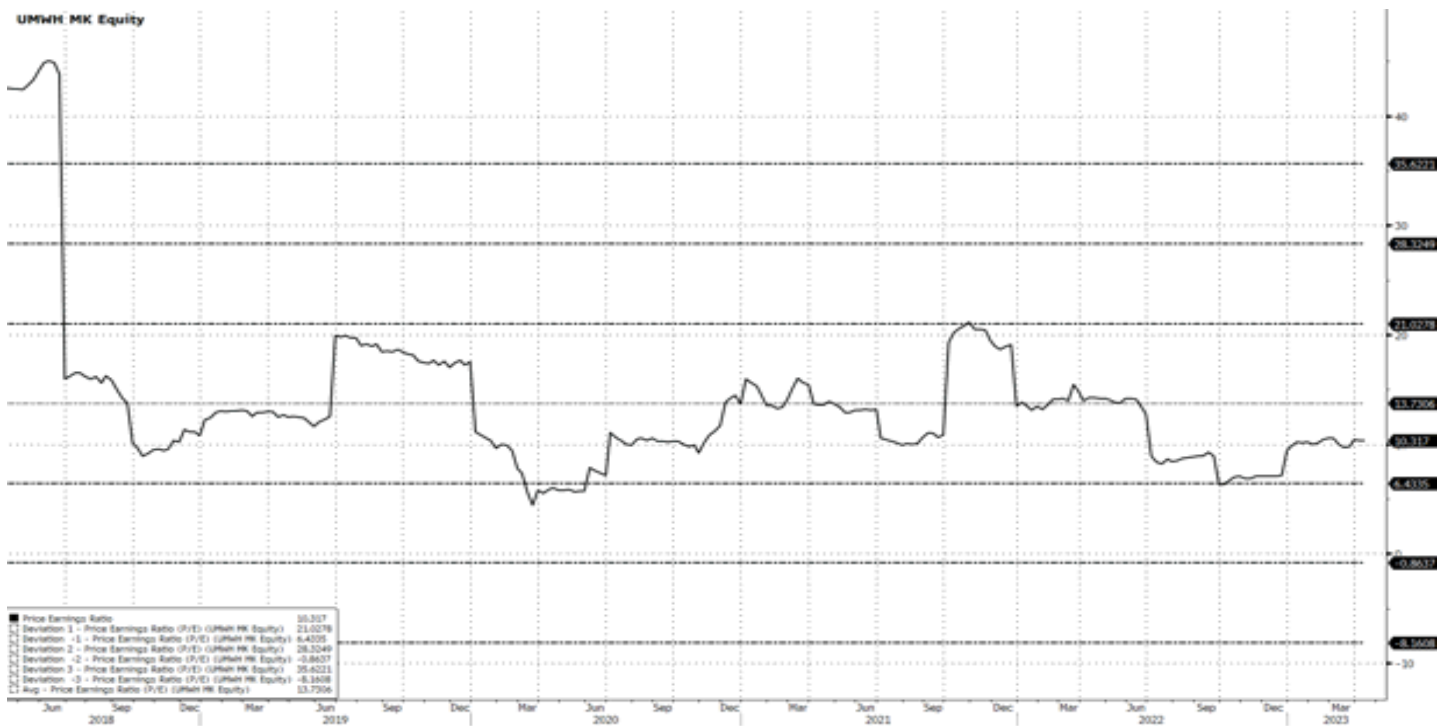
**Recommendation.** We maintain our **BUY** call and SOP-derived **TP** at **RM5.28** – the stock is currently trading at undemanding FY23F PER of 9.7x, a -24% discount to historical mean. We like UMW as it is a prime beneficiary of a strong recovery in auto demand given its dominant market share of ~52% (via 51%-owned UMW Toyota and 38%-owned Perodua). The equipment division meanwhile, is a proxy to recovering business momentum, rising infrastructure projects and commodity demand, whereas aerospace is an indirect reopening play on the back of a recovery in global air travel. While aerospace currently makes up a small portion of our sum-of-parts, we see this as a strategic exposure with room for both horizontal and vertical growth from the expansion of its aero manufacturing capabilities and the strong platform it has as a Tier-1 supplier to Rolls Royce. Meanwhile, UMW’s net cash position stands at RM796m (RM0.68/share, 18% of market cap) which underpins higher dividend payout and M&A potential. Key risk to our call is a significant weakening of the Ringgit, further lockdowns and a worse than expected component shortage situation.

**Table 1: UMW sum-of-parts valuation**

Segments	Valuation Method	Multiple (x)	Value (RMm)	Comments
Automotive	PER	11	5,580.4	FY23F PER; 11x
Equipment	PER	11	782.0	FY23F PER; 11x
M&E	PER	8	301.9	FY23F PER; 8x
Aerospace	DCF		754.5	Equity Value of 25-year Rolls Royce contract (WACC: 8.7%)
Serendah Land	RNAV		871.2	RNAV of Serendah land (500acres@RM40psf)
Perpetual Sukuk Holding co net debt			(1,097.9)	
			(1,028.6)	
<b>Total Value</b>			<b>6,163.6</b>	
Shares out.			1,168.3	
<b>Value/share (RM)</b>			<b>5.28</b>	

Source: Company, MIDFR

**Chart 2: UMW Currently Trading at ~0.5SD below historical mean PER**



Source: Bloomberg, MIDFR

**FINANCIAL SUMMARY**

<b>Income Statement (RMm)</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023F</b>	<b>2024F</b>
<b>Revenue</b>	<b>9,554.6</b>	<b>11,060.8</b>	<b>15,814.4</b>	<b>15,316.3</b>	<b>15,523.2</b>
Operating expenses	(10,423.7)	(10,547.1)	(15,031.0)	(14,738.3)	(14,953.7)
<b>Operating profit</b>	<b>257.7</b>	<b>274.2</b>	<b>605.5</b>	<b>578.0</b>	<b>569.4</b>
Net interest expense	(115.5)	(108.2)	(114.1)	(71.4)	(71.4)
Associates	204.1	268.0	334.9	352.1	350.3
<b>PBT</b>	<b>400.7</b>	<b>482.8</b>	<b>896.5</b>	<b>858.6</b>	<b>848.3</b>
Taxation	(77.7)	32.9	(218.6)	(126.6)	(124.5)
Minority Interest/PERP	118.3	247.4	262.8	284.5	280.0
Net profit	204.6	268.2	415.0	447.5	443.8
<b>Core net profit</b>	<b>240.9</b>	<b>196.8</b>	<b>415.0</b>	<b>447.5</b>	<b>443.8</b>
<b>Balance Sheet (RMm)</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023F</b>	<b>2024F</b>
PPE	2,463.0	2,531.4	2,706.2	2,910.4	3,089.0
Investments in associate	2,015.9	2,170.6	2,362.3	2,714.4	3,064.7
Others	976.5	1,090.7	983.2	983.2	983.2
<b>Non-current assets</b>	<b>5,455.3</b>	<b>5,792.7</b>	<b>6,051.7</b>	<b>6,608.0</b>	<b>7,136.9</b>
Inventories	1,439.3	1,752.2	2,045.7	1,531.6	1,552.3
Receivables	1,059.1	904.2	1,124.3	1,279.7	1,297.0
Others	1,442.5	782.2	387.2	387.2	387.2
Cash & equivalent	2,050.9	2,941.4	2,808.1	2,963.3	2,915.1
<b>Current assets</b>	<b>5,991.8</b>	<b>6,380.0</b>	<b>6,365.4</b>	<b>6,161.9</b>	<b>6,151.6</b>
Share capital	584.1	584.1	584.1	584.1	584.1
Minority Interest	2,549.0	2,646.1	2,789.9	3,004.6	3,214.7
Reserves	3,284.0	3,532.3	3,765.9	4,034.4	4,300.7
<b>Total Equity</b>	<b>6,417.2</b>	<b>6,762.5</b>	<b>7,140.0</b>	<b>7,623.1</b>	<b>8,099.5</b>
Long-term borrowings	1,942.3	2,095.0	1,339.9	1,340.1	1,340.2
Deferred tax liabilities	47.8	48.4	60.8	60.8	60.8
Others	243.6	247.0	274.3	274.3	274.3
<b>Non-current liabilities</b>	<b>2,233.7</b>	<b>2,390.4</b>	<b>1,675.1</b>	<b>1,675.2</b>	<b>1,675.4</b>
Short-term borrowings	523.8	638.1	212.3	212.3	212.3
Payables	2,156.2	2,248.8	3,292.8	3,182.8	3,225.8
Others	116.2	132.9	96.9	76.4	75.6
<b>Current liabilities</b>	<b>2,796.2</b>	<b>3,019.8</b>	<b>3,602.1</b>	<b>3,471.5</b>	<b>3,513.7</b>

Cash Flow Statement (RMm)	2020	2021	2022	2023F	2024F
PBT	400.7	481.0	929.8	858.6	848.3
Depreciation & Amortization	374.1	343.5	340.6	351.8	378.3
Chgs in working capital	419.9	(232.4)	524.8	262.2	4.2
Others	(248.3)	(330.8)	(591.7)	(478.7)	(474.8)
<b>Operating cash flow</b>	<b>946.3</b>	<b>261.4</b>	<b>1,203.4</b>	<b>993.9</b>	<b>756.1</b>
Capex	(700.0)	(406.2)	(509.9)	(700.0)	(700.0)
Others	589.5	790.9	559.4	144.0	143.0
<b>Investing cash flow</b>	<b>(110.5)</b>	<b>384.8</b>	<b>49.5</b>	<b>(556.0)</b>	<b>(557.0)</b>
Dividends paid	(23.4)	(46.7)	(168.8)	(179.0)	(177.5)
Net movement in borrowings	0.2	0.2	(880.0)	0.2	0.2
Others	(214.3)	86.0	(483.8)	(103.9)	(69.9)
<b>Financing cash flow</b>	<b>(237.5)</b>	<b>39.4</b>	<b>(1,532.6)</b>	<b>(282.8)</b>	<b>(247.2)</b>
<b>Net changes in cash</b>	<b>598.3</b>	<b>685.6</b>	<b>(279.7)</b>	<b>155.2</b>	<b>(48.2)</b>
Beginning cash	1,411.5	2,006.5	2,700.3	2,808.1	2,963.3
Forex, Overdrafts & Deposits	41.2	249.3	387.6	0.0	0.0
<b>Ending cash</b>	<b>2,050.9</b>	<b>2,941.4</b>	<b>2,808.1</b>	<b>2,963.3</b>	<b>2,915.1</b>

Key Ratios	2020	2021	2022	2023F	2024F
Operating profit margin	2.7%	2.5%	3.8%	3.8%	3.7%
Core net profit margin	2.5%	1.8%	2.6%	2.9%	2.9%
ROE	5.4%	6.7%	10.0%	10.0%	9.3%
ROA	2.3%	2.3%	5.9%	4.6%	4.4%
Net gearing (%)	6.5%	-3.1%	-17.6%	-18.5%	-16.8%
Book value/share (RM)	3.31	3.52	3.72	3.95	4.18
PBV (x)	1.1	1.1	1.0	0.9	0.9
PER (x)	18.0	22.0	10.4	9.7	9.8

Source: Company, MIDFR

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#### STOCK RECOMMENDATIONS

BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.

#### SECTOR RECOMMENDATIONS

POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.

#### ESG RECOMMENDATIONS\* - source Bursa Malaysia and FTSE Russell

☆☆☆	Top 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆	Top 26-50% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆	Top 51%- 75% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
	Bottom 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell

\* ESG Ratings of PLCs in FBM EMAS that have been assessed by FTSE Russell in accordance with FTSE Russell ESG Ratings Methodology