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Blog Headlines (by Date) Blog Index

MSM Malaysia Holdings - Exploring Expansion

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Johor - Tanjung Langsat refinery on track. We gather that its new c.2.15m metric ton (MT) capacity sugar refinery is on track for completion by 3Q17 and should see full contribution by 1Q18. The new plant will nearly triple its existing capacity (1.1m MT) to 3.25m MT, with the bulk of production targeted for export markets, including Singapore. Expected capex of RM1.10b will be funded through borrowings. Assuming 50% utilisation in 2018, we expect the new plant to nearly double revenue in FY18 to RM4.38b (from RM2.28b in FY14) and increase the EBIT by 80% to RM612.5m (from RM339.5m in FY14). We project that post-expansion, borrowings could hit RM1.44b for a gross gearing of 0.7x. Hence, management noted that they are looking into capital raising in order to reduce its gearing level post-expansion.

Exploring M&A opportunities. Management noted that they are also looking at several potential acquisitions, such as: (i) a 32k ha brownfield Indonesian cane plantation, with 5 existing mills (of which they plan to close down 3 mills), (ii) 42k ha greenfield Sri Lankan plantation land, and (iii) an Indonesian sugar refinery. Management mentioned that for some of these acquisitions, they may consider a JV or asset swap with its strategic alliance partner. We understand that MSM is looking to raise at least USD400-500m (RM1.7-2.1b) through cash call to fund its expansions plan.

Looking at cash calls. We gather that MSM is likely to propose at least one cash call for the expansions discussed above to reduce its gearing, fund expansions and widen its share base. Potential structures include a rights issue with possible share split, and we gather that MSM is also exploring an ESOS program. All-in, we estimate capital injections to hit c.RM2.25b, should MSM go through with its M&A plans, which could increase total equity to RM4.31b.

Likely earnings-accretive. Based on management's guidance, we believe that the key objectives of the capital raising exercise are to: (i) raise funds for its expansion plans, and (ii) reduce gearing to a comfortable level. Management noted that its internal hurdle rates for its new refinery and M&A are 25% and at least 15%, respectively, implying a blended hurdle rate of 18% vs. MSM's current ROE of 12.5%. Assuming total expansion cost of RM3.20b (RM1.10b for new refinery, and RM2.10b for M&As) and target gross gearing of 30%, we estimate MSM could raise RM2.25b in a 1-1 rights issue to meet its funding needs (assumed rights price of RM3.05 at an 35% discount to the last price of RM4.69 (TERP of RM3.81)). We also assume the expansion will start contributing from FY18. To maintain MSM's current PER of 12.7x, the expected ROE of its expansion plans must be a minimum of 5.5%. However, to ensure FY18 EPS is accretive, the expected ROE of its expansion plans must be at least 8.8%, implying a FY18E PER of 10.2x. As such, we think that if management can meet its projected hurdle rates for its expansion plans, the cash call is likely to be earnings-accretive to shareholders from FY18 onwards. Based on its current PER of 12.7x, the implied FY18E TP range is RM3.86-RM4.73 or 0%-23% upsides based on total expansion ROEs of 5.5%-8.8%.

NOT RATED with FV of RM5.25. We assign a Fair Value of RM5.25 to MSM based on a target PER of 13.0x applied to FY16E EPS of 40.4 sen. Our PER is based on the three-year historical average PER which we think is fair as MSM's long-term expansion growth potential is offset by short-term higher gearing levels. Any potential re-rating catalyst is dependent on the quality of MSM's potential acquisitions.

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