21 May 2018 | Sector Update

Automotive

***Maintain* POSITIVE**

First thoughts on zero-rated GST

INVESTMENT HIGHLIGHTS

- **GST/SST tax-free window to artificially boost TIV**
- **However, temporary demand vacuum and car price adjustment expected post-SST re-introduction if maintained at previous 10% rate**
- **Generally, GST rollback expected to put more money into consumers' pocket, structurally lifting sentiment and spending power**
- **Bermaz Auto (BUY, TP: RM2.70/share) is our top pick for a solid 35% earnings CAGR and attractive 7% yield, followed by Tan Chong (BUY, TP: RM2.05), UMW (BUY, TP: RM7.11) and MBM (BUY, TP: RM3.10)**

Zero-rated GST. The Government has decided to reduce GST rates to zero (from 6%) effective 1st June 2018. Whilst SST is supposed to be re-introduced, this is expected to be within a 2-3 months period. The implication is that consumers will likely take advantage of the GST/SST-free window which will artificially drive up TIV. Beyond this, given that purchases would have been brought forward coupled with a re-introduction of SST, we anticipate some weakness before demand normalises.

Auto players already rolling back GST charges. In order to avoid a vacuum in demand between now till implementation of zero-rated GST, key auto players have decided to provide some form of GST rebate for the period leading up to 1st June. Others meanwhile, have already announced price reductions (of between 5%-6%) as a result of the zero-rated GST decision. The decision to absorb GST for the period of ~13 days to 1st June is likely to have some impact on the sector's 2Q18 earnings, albeit temporary.

EXHIBIT 1: PLAYERS' REACTION TO ZERO-RATED GST ANNOUNCEMENT

Marque	Measure (interim till SST is introduced)
UMW Toyota	Price reduction of 5%-6% for all models effective 1st June
Honda	Price reduction of 5%-6% for all models effective 1st June
	To absorb GST for selected model for period up till 31st May: City, Civic, HRC, CRV
	Offers Ramadhan cash rebate
Nissan (Tan Chong)	Refunds of up to 6% of selling price for period up till 31st May
Subaru (Tan Chong)	Refunds of up to 6% of selling price for period up till 31st May
Proton	Offers service vouchers equivalent to 6% GST for period up till 31st May
	Offers 6% periodic service discount up till 31st May
Perodua	Offers cash rebate for 6% GST for period up till 31st May
	Price reduction of 5%-6% effective 1st June
VW	Price reduction of 5%-6% for all models effective 1st June
BMW	Price reduction of 5%-6% for all models effective 1st June
Mini	Price reduction of 5%-6% for all models effective 1st June

Source: PaulTan, MIDFR

No issue for existing stock. Our channel checks suggests that input GST that have been charged on existing inventory can still be reclaimed, which means there is no reason for dealerships to provide excessive discounts to clear off existing inventory or to freeze purchases from distributors, as was the case when GST was implemented - during the transition to GST, dealers were double-taxed as they were only allowed to reclaim 20% of the SST paid on stocks in hand, on top of being charged the 6% GST introduced from April 2015.

Minimal impact on dealer purchases. On top of this, given that most key distributors have already announced GST rebates even prior to the zero-rated GST implementation in order to avoid a vacuum in demand, we anticipate little impact to the flow of purchases by dealers from distributors for the period leading up to 1st June.

SST re-introduction might impact pricing beyond "tax-free" period. If SST is reinstated at the previous 10% rate, car prices are likely to rise. On simple logic, car prices are expected to increase marginally (versus prices under the current 6% GST rate), which is the opposite of what happened under GST in 2015 when car prices reduced by 1%-3%. Given the GST/SST-free period however, the magnitude of increase from that base could be quite meaningful. Nonetheless, detail of the SST re-introduction is still scant and it would be too preliminary to conclude at this stage.

Countered by improving spending power? In 2017, GST collection was reported at RM44b which is a considerably larger amount compared to SST collection of RM17b (back in 2014). The differential (which works out to an estimated 2%-3% of GDP), is essentially being put back into consumers' pockets. We see this as a strong structural factor to lift consumer sentiment and drive TIV improvement beyond the temporary demand volatility during the transition from GST to SST.

Beneficiary of the strong Ringgit. Taxes aside, the strong Ringgit is a big positive for auto players under our coverage and underpins our bullish sector call. UMW Toyota has large exposure to USD given that all its imported CKD kits and CBUs are transacted in USD. Given low localisation rates (of between 20%-60%) relative to the national makes (of 80%-95%), we estimate around half of total component costs are imported. Tan Chong is estimated to have circa 80% (of total imported cost) exposure to USD imports with the rest in JPY. Every 1% change in the USD impacts our FY18F by 4.7% for UMW (Group) and 64% for Tan Chong. As Tan Chong's earnings is close to break-even point, its bottomline is very sensitive to forex changes.

Bermaz Auto is a key beneficiary of the Ringgit strength against the JPY as its imports are 100% exposed to the latter; BAuto is exposed to the JPY via CBU imports, whereas CKDs i.e. the CX5 and Mazda 3 models are purchased at a fixed Ringgit price from 30%-owned Mazda Malaysia Sdn Bhd (MMSB), which is the importer and assembler of Mazda CKDs. To make this possible, MMSB absorbs JPY volatilities from CKD imports; which means that MMSB also benefits from the current Ringgit strength. We estimate that every 1% strengthening of the Ringgit against the JPY impacts BAuto's FY18F (FYE April) earnings by 3%. Perodua is another beneficiary given its exposure to the JPY (and partly USD). Every 1% change in the JPY impacts our FY18F by 1%. UMW is the largest local shareholder of Perodua with a 38% stake followed by MBM with an effective 22.6% stake.

EXHIBIT 2: EARNINGS SENSITIVITY TO FOREX

	FY18F earnings impact for every 1% change in USD/JPY
UMW Holdings	4.7%
Tan Chong	64.0%
Bermaz Auto	3.0%
Perodua	1.0%

Source: MIDFR

BAuto (TP: RM2.70) remains our top sector pick. Key catalysts over the next 12 months:

1. **An 11%yoy Mazda TIV growth** (FY19F) coupled with margin expansion driven by full year impact of new CX5 from 3QFY18 onwards
2. **Ringgit strength** against the JPY
3. **A more than doubling in associate earnings contribution** to group (via 30%-owned Mazda Malaysia SB and 29%-owned Inokom) given export market expansion to South East Asia (ex-Vietnam) and re-acceleration in production for the domestic market.
4. **Launch of CBU CX8** in 2QCY18 and CKD variants in CY19F.
5. **Attractive dividend yield of 7%** - net cash accounts for 10% of market cap coupled with solid 9% FCFE yield (FY19F). Our payout assumption is capped at 80% vs. historical 80%-113% payout.

Our contrarian BUY on UMW (TP: RM7.11) is re-affirmed. Key catalysts: **(1) A deleveraged balance sheet post** UMWOG demerger allows room for acquisitive growth and possible resumption of dividend payouts – successful acquisitions from PNB and MBM to increase Perodua stake are strong share price catalysts **(2) Reversal of prior years' market share loss**, structural cost reduction and pricing advantage from UMW Toyota's EEV-focused strategy **(3) Redevelopment of UMW's 830 acres Serendah land** which will unlock value of the asset – easily worth 40sen/share on our estimates (**4) A more than quadrupling of M&E division earnings** once its aerospace division reaches full scale production.

MBM Resources (BUY, TP: RM3.10) is a cheap proxy to Perodua's volume expansion and the spillover on its parts manufacturing and Perodua dealership units. Attractive 39%yoy earnings growth (FY18F) for less than half FY18F BV and on the back of a lean balance sheet (9% net gearing). Key catalysts: (1) Strong growth in Perodua TIV on the back of the new MyVi and potentially a new SUV to fill up a vacum in its model mix (2) A stronger Ringgit (3) A recovery in industry production driven by new national car launches.

Tan Chong is also our non-consensus BUY (TP: RM2.05) as a deep value play into the sector's earnings recovery driven by the strong Ringgit and a bottoming in market share. Having seen share price fall some 40% in the past 24 months, Tan Chong now trades at just 0.4x FY18F PBV (which is lower than even its historical trough PBV of 0.5x) amid a potential turnaround in earnings over the next few years. Key catalysts include: (1) Resumption of new model launch in FY18F (2) Sustained Ringgit strength (3) Narrowing in losses from Indochina operations.

VALUATION AND RECOMMENDATION

		Shr Price	EPS (sen)		PE (x)		P/BV	ROE	Div Yield	Target	Total
Companies	**Rating**	**(RM)**	**CY18F**	**CY19F**	**CY18F**	**CY19F**	**(x)**	**(%)**	**(%)**	**Price (RM)**	**Upside (%)**
Bermaz Auto	BUY	2.18	16.7	20.1	13.0	10.8	4.7	35.2	7.1	2.70	31.0
Tan Chong	BUY	1.67	3.1	9.0	54.7	18.5	0.4	1.1	1.8	2.05	24.6
UMW	BUY	6.30	31.7	47.5	19.9	13.3	1.1	5.4	2.6	7.11	15.4
MBM	BUY	2.40	25.9	31.5	9.3	7.6	0.5	5.5	2.7	3.10	31.9
Average					***14.1***	***10.6***	***1.7***	***11.8***	***3.5***		

Source: Bloomberg, Companies, MIDF

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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 *rise* 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 *fall* 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.