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OCTOBER 2008

# MALAYSIA EQUITY STRATEGY



## WHO DARES WIN

KINDLY REFER TO THE LAST PAGE OF THIS PUBLICATION FOR IMPORTANT  
DISCLOSURES

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24 October, 2008

KLCI: 891.32 (-38.32% YTD)

FBM30: 5797.09 (-38.0% YTD)

## WHO DARES WIN: WINNERS IN TROUBLED TIMES

### EXECUTIVE SUMMARY

- The world's economy is in turmoil. The U.S. economy is expected to contract in 3Q08 through to 2Q09. If the situation is not handled carefully, the recession in the US can deteriorate into a depression. We expect 0 to -1% contraction in US GDP in 2009.
- Malaysia is in a better position to weather the storm compared to that during the 1997-98 crisis. There is no tsunami that knocked individuals and businesses off their footing, with the exception perhaps of the sharp fuel price hike in June. The expected contraction in external demand is expected to be offset by locally engineered demand. The public sector, which has been a potent force of the local economy, has been judiciously managed such that there are pump-priming bullets to spare for a few years to come. GDP growth is expected at 3-4% next year.
- We expect a long and painful process of the world unwinding its excesses. A Democrat win in the U.S. could be the redeeming factor, which will allow a clean-up of 8 years of Bush administration's economic mismanagement. The dollar is expected to respond positively and global portfolio funds will be attracted to U.S. capital markets, which are already at depressed valuation. Emerging markets will be in limbo for one or two years, before they finally benefit from a spillover from the U.S. There will be a flight to safety and liquidity. Yields on risk-free government securities are expected to fall accordingly, although the OPR may remain unchanged as fiscal is preferred over monetary stimulus for the time being.
- The KLCI could find the trough at the 820 level over the next 12 months based on the price-to-book multiple of 1.2x, which was the lowest recorded this decade. It could be rangebound at the 820-950 level throughout the next 2 years. Investment horizons, therefore, will have to be stretched.
- Looking for value in troubled times is not such a straightforward process. There will be temptations, as valuations are depressed across the board. We advocate companies which are focused on their core competencies, and those that are expected to be benign to minorities. Look for potential capital management exercises and avoid companies that stray from their core focus.
- Our list of likely winners include TM, Tenaga, Proton, Public Bank, Dialog, Parkson, IOI Corp, UMW, Lion Industries and AEON. Regardless of the industry, we believe that in trying times, corporate leadership matters, and each company charts its own route out of the storm. 

## A. THE WORLD IN TURMOIL

### i. Taking stock of the damage

**“Once in a century”**: The unfolding meltdown in the global financial markets is without doubt, the most severe in history, based on the quantum of losses suffered thus far. The former Fed Chairman Alan Greenspan has described the current crisis as that which occurs “once in a century”. This will inevitably draw parallels with the U.S. Great Depression in the 1930s.

**Depression can be averted if handled wisely**: As evident from the table below, the circumstances surrounding the U.S. Great Depression are different from what is being experienced now, especially with regard to the causes and the policy responses. It would be living a denial to expect that the U.S. will escape a recession — chances are the world’s biggest economy is already mired in one. A depression is a separate matter. Joseph Stiglitz, the nobel laureate, is of the opinion that the Bush administration is capable of dragging the economy into a depression based on its track record in handling the Iraq war and the Katrina hurricane.

#### THE GREAT DEPRESSION

CAUSE	The Fed raised interest rates to stem the supply of cheap credit in order to arrest the soaring house and equity prices. This created the domino effect that triggered the depression.
EQUITY MARKET - incidences of 1-day crash	Crashed in 1929. On Oct 28 (-14%), on Oct 29 (-12%), on Nov 6 (-10%).
EQUITY MARKET - From peak to bottom	1929-1932 (-80%)
UNEMPLOYMENT RATE	25% in 1933 and stayed above 10% until early 1940s
BANK FAILURES	9,000 banks between 1930-1933
GDP	In nominal terms, US GDP in 1940 was still lower than that in 1929. It only recovered in 1941.

**Banking crisis in the U.S. the source of problem**: It is now undeniable that losses suffered in the U.S. as a result of exposure to the sub-prime mortgage crisis are to blame. The International Monetary Fund (IMF) estimates that losses on US-based loans and securities may hit USD1.4 trillion, and has projected that credit growth may fall to 0% in 2009. The number of financial institutions which have collapsed or need to be rescued, including big names such as Lehman Brothers and Merrill Lynch, would not have been imaginable as recent as a year ago. History shows that whenever there is a banking crisis, an economic slump, with all that entails - mass redundancies, falling house prices, widespread bankruptcies - invariably follows.

**Equity loss has been severe**: Most stock markets around the world reached their respective all-time highs in 2007 or early 2008. From the peak, the decline in value has been severe, although still short of the damage experienced during the Great Depression. As at Oct 6, the market

## DESTRUCTION IN MARKET CAPITALISATION

	Market cap (USD' trillion)		Loss in value		
	Peak	As at 6 Oct, 08	USD trillion	% change	as % of nominal GDP
World *	62.57	37.84	-24.73	-39.5	-48.4
US	19.14	12.55	-6.59	-34.4	-47.7
Japan	5.26	3.29	-1.97	-37.5	-45.1
China	4.75	2.06	-2.70	-56.7	-82.2
United Kingdom	4.27	2.51	-1.77	-41.3	-64.7
Hong Kong	2.99	1.51	-1.48	-49.5	-715.9
France	2.97	1.65	-1.32	-44.4	-51.4
Germany	2.23	1.29	-0.95	-42.4	-28.7
India	1.90	0.78	-1.11	-58.6	-94.9
Australia	1.51	0.85	-0.66	-43.7	-80.0
South Korea	1.24	0.55	-0.69	-55.6	-71.2
Singapore	0.54	0.30	-0.25	-45.2	-152.8
Malaysia	0.36	0.21	-0.15	-40.8	-80.1
Indonesia	0.28	0.12	-0.16	-55.7	-36.0
Thailand	0.22	0.12	-0.10	-45.7	-40.7

\* based on 49 countries

Source: Calculated by MIDF Research based on Bloomberg's data

capitalisation of the world's equity market had been destroyed by almost 40%, or equivalent to 49% of nominal Gross Domestic Product. Four Asian countries, namely India, China, South Korea and Indonesia are among those that suffered the most, having declined by 55-60%.

**Downturn in Asia preceded that in the Western Hemisphere:** Despite being the source of the current global economic and financial malaise, the U.S. equity market has suffered the least among major markets, having declined by "only" 34% from the peak. Markets in Asia have been subjected to heavy correction since late 2007/early 2008. The KLCI has certainly been sliding since early March. The Dow Jones did not stage a bear run until May 2008.

**RM0.6 trillion and counting:** The amount of losses and writedowns by financial institutions worldwide are estimated to have reached USD593 billion as at 9 October, 2008 based on data compiled by Bloomberg. This is by far the largest amount in history and is the source of the much-feared credit crunch worldwide. As aforementioned, the IMF expects this to balloon to USD1.4 trillion.

Total Loss by Region (USD' billion)	Loss	Capital raised
Worldwide	593.1	443.3
Americas	339.9	244.9
Europe	228.3	175.8
Asia	24.9	22.5
	<b>1186.2</b>	<b>886.5</b>

(Source: Bloomberg as at 8 Oct)

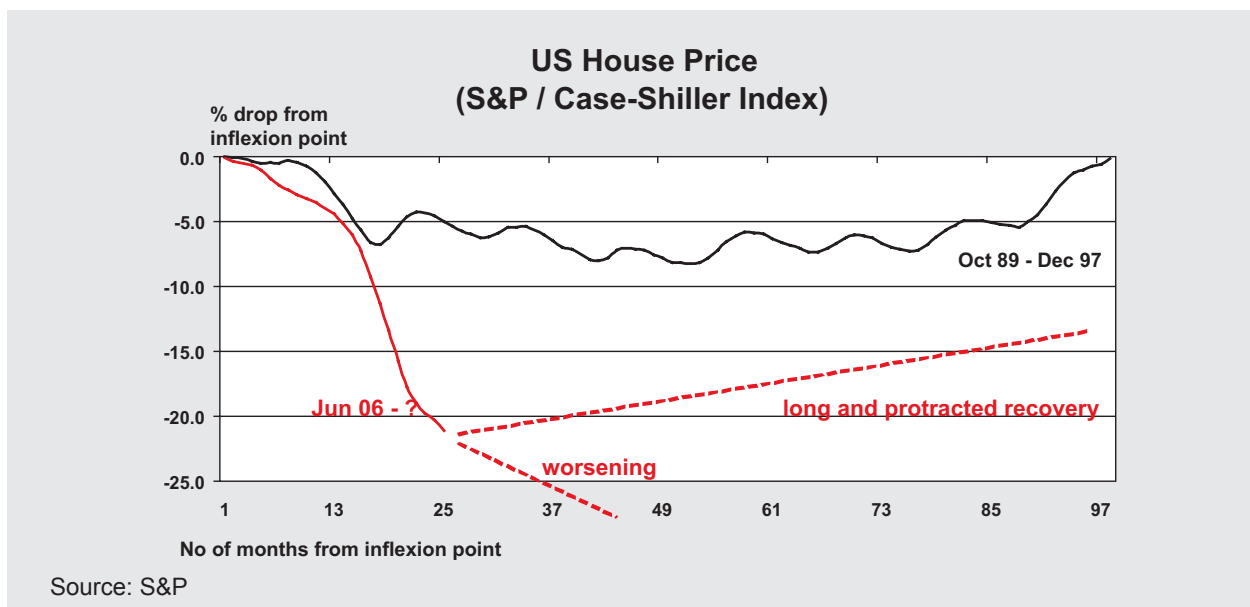
**House prices have fallen in the U.S., but yet to hit the trough:** From

Loss by institution (Top 20) USD'b	Loss	Capital raised		Loss	Capital raised
Citigroup	61.0	71.0	Lehman Brothers	13.8	13.9
Wachovia Corp	52.7	11.0	Royal Bank of Scotland	13.5	22.2
Merrill Lynch	52.2	29.9	Credit Suisse	10.1	3.0
Washington Mutual	45.6	12.1	Well Fargo	10.0	5.8
UBS	44.2	27.3	Deutsche Bank	9.9	6.0
HSBC	27.4	5.1	Fortis	9.0	22.1
Bank of American	27.4	30.7	Credit Agricole Banks	8.4	8.1
JP Morgan Chase	18.8	19.7	Barclays	7.3	17.3
Morgan Stanley	15.7	14.6	Canadian Imperial Bank of Commerce	6.7	2.6
IKB Deutsche Industriebank	14.1	11.6	Mizuho Financial Group	6.7	0.0

(Source: Bloomberg as at 8 Oct)

the peak in June 2006, house prices in the U.S. had fallen by an average 21.1% by July 2008 (Source: S&P/Case-Shiller Home Price Index), and it is still falling. The prices will continue to fall for many reasons, one of which is due to the continual reset of the Adjustable Rate Mortgages, that are going to cause more over-leveraged homeowners to default on their mortgages. In August 2007, Yale University economist Robert Shiller warned, “the examples we have of past cycles indicate that major declines in real home prices—even 50 percent declines in some places—are entirely possible going forward from today or from the not too distant future.”

**Either worsening or protracted languish:** The chart showing the Case-Shiller home price index in the U.S. compares the severity of the current downturn in U.S. house prices with that in 1989-97. Two years into the crisis, house prices in the U.S. have already fallen about 20%, compared with that in 89-97, when prices retreated by less than 10% from the inflexion point (the start of the crisis). Moving forward, the house market in the U.S. can either continue to go downhill or stage a gradual but protracted recovery (see chart).



**No recovery earlier than 2009:** A housing price correction can last for many years. Price can stay depressed or even depreciate further because the stock of property foreclosed will take time to be cleared, some at firesale prices. At this juncture, the market is still looking for a bottom, and at the rate equity prices are falling and more banks going under, we expect a “second round” price depreciation over the next few quarters.

## ii. Rescue initiatives and policy actions

**Policy responses have been “reactive”:** The cause of the current crisis has already been popularly attributed to the Fed, for keeping a low interest rate policy in the first half of this decade which resulted in the housing bubble and the sub-prime funding. If this were to develop into a depression, the policy makers will again be faulted for responding too little too late. Thus far, policy reactions have been rather reactive. Only after the stock markets around the world plunged on 6-7 October, did several central banks took the coordinated move to cut interest rates by 50 basis points.

**“In chaos, there is order”:** While the policy response appear to be reactive and haphazard, the objective is clearly to avert a liquidity crunch by ensuring:

- The solvency issues of financial institutions. This entails the choice of letting the institution to fail or go into bankruptcy; rescuing selected institution by injecting taxpayers money in order to avert a systemic risk; and arranging for troubled institution to be taken over by rivals.
- The availability of liquid funds. In this regard, the authorities have pumped in liquidity into the money market, and have tried to offset the spiralling credit risk premium by reducing the market risk through lower intervention rates.

## iii. What else can go wrong

**The unravelling of the excesses in the U.S. is still ongoing:** The process of unravelling years of cheap credit and inflated asset prices is likely to be a longer-than-expected affair. More U.S. banks are expected to capsize, and the contagion to Europe is not expected to abate any time soon. A schematic presentation of how the crisis has thus far unfolded, and is expected to unravel further in months to come is shown below. This is based on the noted economist Roubini, who has been credited with predicting the crisis.

**Two groups of financial institutions are at risk:** High on the risk list are the leveraged hedge funds and private equity firms involved in leveraged buy-outs (LBOs). Roubini foresees the crisis in hedge funds to unravel over a period of two years. The collapse of Long-Term Capital Management (LTCM) in late 90s and its subsequent bail-out is testament that hedge funds can also pose a systemic risk. Meanwhile, the private equity firms and the LBOs are going to be a longer-drawn affair, as the lenders have to

## Anatomy of a meltdown



Firstly, it was Bear Stearns. The Federal Reserve extended its lender-of-last-resort support to systemically important broker-dealers. But this proved inadequate. Lehman Brothers bit the dust. Merrill Lynch would have faced the same fate had it not been sold. Morgan Stanley and Goldman Sachs abandoned the pure investment banking model and moved into deposit taking.

Fannie Mae and Freddie Mac, AIG, Washington Mutual and more than 300 mortgage lenders.

Funds invested in illiquid instruments in order to obtain higher returns. Once these investments went bust, panic ensued among investors, leading to a massive run on such funds. In another radical departure, the US extended deposit insurance to the funds.

A bank-like run on hedge funds is highly possible. Hundreds of smaller, younger funds that have taken excessive risks with high leverage and are poorly managed may collapse. A massive shake-out of the bloated hedge fund industry is likely in the next two years.

The private equity bubble led to more than \$1,000bn of leveraged-buyouts that should never have occurred. These LBOs are protected by the absence of traditional default triggers etc. Expect ugly bankruptcies to follow. Even the largest LBOs, such as GMAC and Chrysler, are now at risk.

Contagion of US to Europe is inevitable. European institutions hold a lot of toxic US securities. Domestic housing and credit bubbles are bursting, especially in Baltic States and southern Europe. Swedish, Austrian and Italians have exposures to these vulnerable assets.

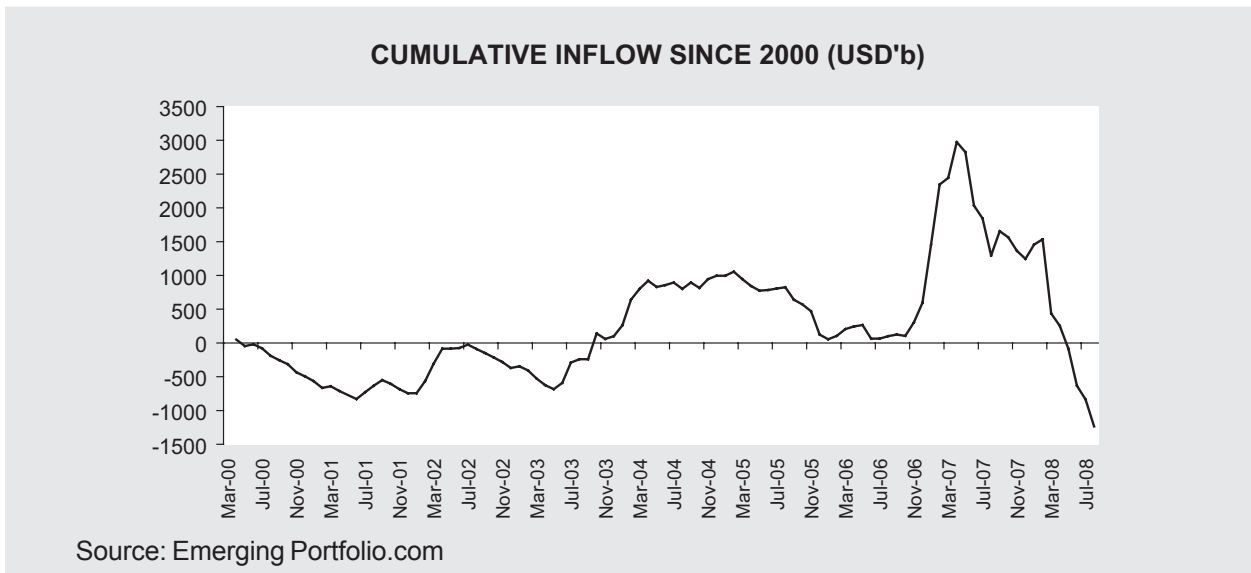
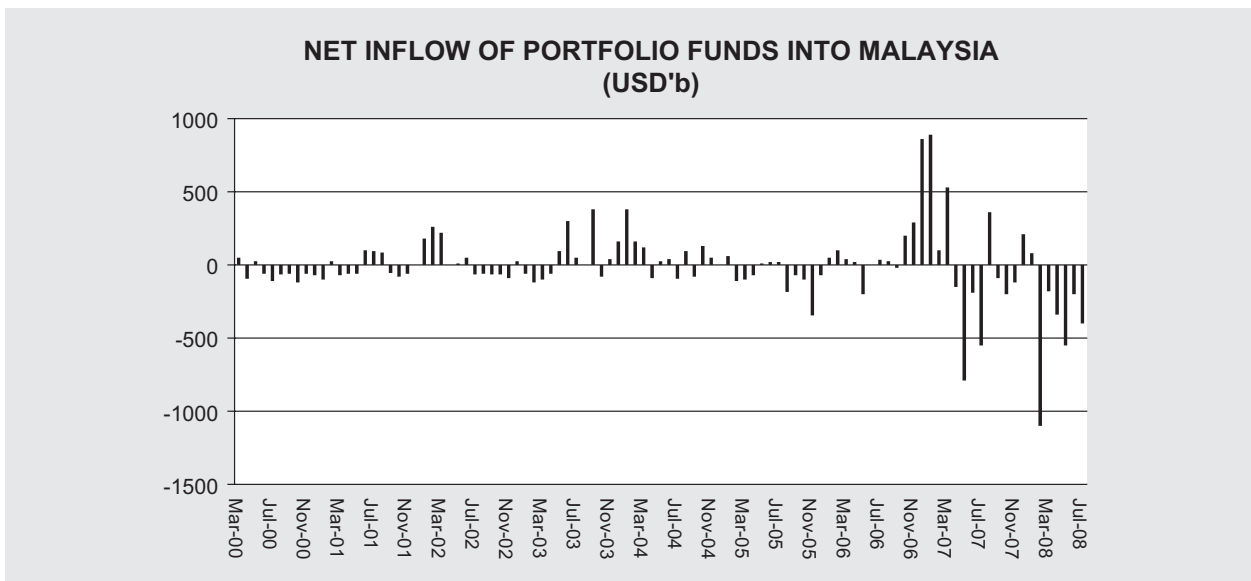
overcome the in-built protection of the borrowers. Ultimately, it is expected that Europe will be dragged into a slowdown and the world will fall into recession, if it is not already in one.

## B. IMPACT ON MALAYSIA

### i. Flow of funds

**Net outflow since March:** Malaysia has been experiencing a net outflow of portfolio funds since March this year, based on data surveyed and compiled by Emerging Portfolio.com (see chart next page). This coincided with the heavy correction in the KLCI from end Feb-2007 onwards (the KLCI peaked at 1, 516 in November 2007). The outflow has been unabated, as figures up until August have shown. Interestingly, the fund managers began pulling out from countries such as China (October 07), Singapore (Jan 08) and Hong Kong (Nov 07) earlier than that from Malaysia. However, the flow had been two ways for the markets, with China still attracted funds as recently as in August 2008, and Singapore in April/May 08.

**Now its all gone!:** Based on cumulative numbers since early 2000, one can safely assume that the foreign portfolio funds have left the country by



Source: Emerging Portfolio.com

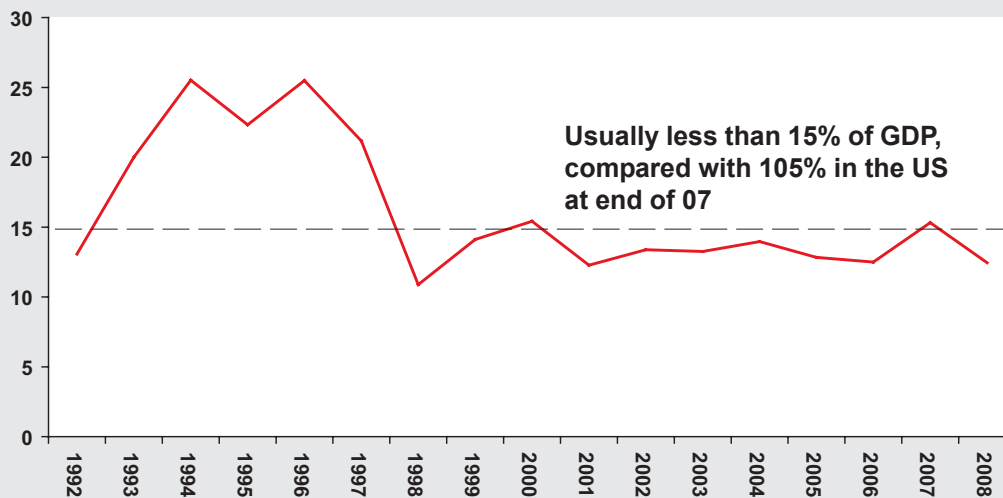
now (see chart above). The average foreign shareholding for KLCI's top ten companies had shrunk from 29% at the end of 2007 to about 20% in September 08, and heading towards the all-time low of 14% in October. There is therefore less risk now of the KLCI suffering a sharp drop as a result of foreign investors dumping their shares. This was manifested when the KLCI outperformed regional markets during recent selloffs.

**ii. The wealth effect and its relevance on Malaysia**

**Well documented evidence of wealth effect on the economy:** Empirical evidence of the impact of destroyed wealth on real activity is well documented. Economists make a distinction between financial wealth and housing market wealth, and examine the significance of each class of wealth on real economic activity. Some of the findings are:

- There are distinct linkages between the stock market and consumer spending—and by extension, GDP growth. A study by Carl Case and

### MARKET CAPITALIZATION\* AS % NOMINAL GDP



\* Monthly average of Bursa Malaysia's Main Board  
Source: Bloomberg, Department of Statistics' National Income

Ray Fair titled “Stock Market and the Economy” suggests that the U.S. economy benefited immensely during the last bull phase. Between 1995 and 2000, in the largest stock market boom in U.S. history, the Standard & Poor’s 500 Index rose 226%, adding \$14 trillion to household wealth. U.S. GDP growth increased to 4.5% a year, compared to the normalised 2.5%, with the wealth effect accounting for 1.5 percentage points. Conversely, the October 1987 market crash wiped out a trillion dollars in market capitalisation, resulting in a \$40 billion drop in consumer spending in 1988, or about 1.4 percentage points of GDP.

- An International Monetary Fund (IMF) paper titled “Is There a Stock Market Wealth Effect on Emerging Markets?” (by N. Funke) for 16 emerging markets contends that over a three-year period, a 10% decline (increase) in stock prices is associated, on an average, with a 0.2-0.4% decrease (increase) in private consumption.

**Stock market influence on the Malaysian economy has waned since the '98 financial crisis:** The market capitalisation of Bursa Malaysia as a percentage of Malaysia’s nominal GDP has not reached the levels seen prior to the financial crisis, even when the KLCI broke the 1,500 level last year. This is significant as it suggests that the wealth effect of changing equity prices carries less potent impact on consumption spending. This is partly attributable to the growth in “risk-pooling investment vehicles” such as unit trusts, investment linked insurance funds and structured products.

**Housing wealth have a larger impact on household consumption in the developed countries:** Most studies have concluded that consumption spending is more sensitive to changes in housing prices than that in stock prices in the U.S. and developed markets. (“Comparing Wealth Effects: The Stock Market Versus The Housing Market” Case, Quigley, Shiller). For the developed countries, a 10% increase in housing wealth is estimated to increase consumption spending by 1.4%, but a similar increase in stock

US 2009 GDP MATRIX		% fall in the price of houses						
		10	15	20	25	30	35	40
% fall in the price of equity	10	0.5	0.1	0.0	-0.2	-0.3	-0.5	-0.6
	20	0.0	-0.2	-0.3	-0.5	-0.6	-0.7	-0.9
	30	-0.3	-0.5	-0.6	-0.7	-0.9	-1.0	-1.2
	40	-0.6	-0.7	-0.9	-1.0	-1.2	-1.3	-1.4
	50	-0.9	-1.0	-1.2	-1.3	-1.4	-1.6	-1.7
	60	-1.2	-1.3	-1.4	-1.6	-1.7	-1.9	-2.0
	70	-1.4	-1.6	-1.7	-1.9	-2.0	-2.1	-2.3

## Assumptions:

1. Every 10% fall in house and equity price will reduce consumption by 0.4% (based on Shiller et al empirical finding)
2. Consumption makes up 70% of US GDP
3. The remaining 30% non-consumption component of US GDP continues to grow at current annualised GDP rate at 2.8%

Source: MIDF Research

wealth has negligible impact on consumption. For the U.S., the impact on consumption is equal for housing and stock wealth at 0.4% each.

**U.S. and the developed countries will slow down due to the negative wealth effect:** The combined effect of financial and housing wealth destruction will have a negative impact on the U.S. and developed economies. The IMF expects the U.S. to grow by only 0.1% in 2009. We believe that this could be lower given the further deterioration in equity value after the forecast was made. Assuming that house prices fell 15% this year and equity prices down by 40%, the U.S. should be staring at a -0.7% contraction. In 1982, it contracted -1.5% (see potential range of U.S. GDP in 2009 in the matrix above).

### iii. Revisiting the macroeconomic numbers

**Much depends on the U.S.....** Malaysia will inevitably feel the brunt should the U.S. GDP growth were to slide into negative territory. We are looking at a base-case scenario of Malaysia's GDP growth of 3.0% - 4.0% in 2009.

FORECASTS	Latest	2008 *	2009F	2010F
GDP growth %	-	5.50%	3.0 - 4.0%	4.5 - 5.5%
USD/RM (end of)	3.495 (13 Oct)	3.50	3.60	3.70
Interest Rate (end of)				
Overnight Policy Rate	3.5	3.5	3.5	3.5
3-month KLIBOR (fixing)	3.66	3.68	3.55	3.6
3-year MGS (mid %YTM)	3.82 (13 Oct)	3.50	3.20	3.10
5-year MGS (mid %YTM)	3.89 (13 Oct)	3.70	3.30	3.20
Inflation Rate (annual % chg)	8.5 (Aug)	5.8	4.5	2.5
Crude Oil (WTI Spot) (average)	112.6	105	80.0	70.0
* estimates				

Much of the growth will emanate from pump priming measures as the federal government still has the capacity to do so.

**... and the fate of the U.S. depends on the outcome of Nov election:**

More importantly, the fate of the U.S. economy will depend on who were to prevail in November. A Republican win will see a continuation of a large part of the Bush's administration policy. A Democratic win is likely to see a greater commitment towards fiscal prudence, and a return to the strong dollar era reminiscent of the Clintonian days.

**Either outcome is unlikely to help Malaysia's case in the short run:**

Malaysia's equity market should be bracing a tough 12-months as foreign money is unlikely to return so soon (see Section C: Malaysian Equity)

## C. MALAYSIAN EQUITY

### i. Earnings prospects

**Disappointing 2008 corporate earnings:** Strong expectations at the beginning of the year for robust growth in corporate earnings have left many disappointed. The deterioration in expectation has been severe — from 22% earnings growth expected during early this year, to only 2.2% currently (see Table below).

Tracking Corporate Earnings Growth Expectations		
	FY 08	FY 09
1Q08	22.0%	17.0%
2Q08	14.0%	9.9%
3Q08	2.5%	3.6%
Current expectation	2.2%	1.9%

*Source: Compiled by MIDF Research based on various sources. The universe is 80% of KLCI*

**Four factors in general will impinge upon the earnings of listed companies in 2009:**

- a) Depressed commodity prices, the focus of which will be on prime commodities such as crude oil, crude palm oil and steel.
  - Crude oil price may drop to USD50pb in the extreme case where demand collapsed and the greenback strengthened. Beneficiaries would include transportation, plantation, manufacturing, and the consumer sectors.
  - CPO price may weaken in tandem with the trend in crude oil. Demand is weakening while supply from Indonesia is causing a disequilibrium. Technically, immediate support is seen at RM1400/mt, with resistance at RM1940/mt.

- Local steel millers experienced a strong 1H08 with net profit growing by more than 150% y-o-y. So far, steel prices have taken a breather, falling 21.7% q-o-q to USD\$940/MT, with the market conditions pointing towards a further consolidation.
- b) Slowdown in consumer demand, underscored by weak employment outlook. The main impact is seen on the potential weakening of consumption related activities (i.e. wholesale and retail as well as utilities) as well as transport sector activity. On the demand side, private consumption growth could weaken due to the deterioration in real disposable income. The costs of doing business could also rise that may result in moderation in private investment.
- c) Uncertain global economies. The impact is yet to be fully felt but it certainly has affected sentiments given that the U.S., EU, Japan and China are Malaysia's main business partners, combining close to 44% of total trades.
- d) Currency Effect. For net importers, the weaker RM is definitely a concern that will undermine their earnings prospects especially for the electronics and electrical sector. For companies with sizeable non-RM debts such as Tenaga Nasional, expect further provisions for currency translation loss in the upcoming results.

## ii. Market valuation

### Market to be generally depressed, and sideways for an extended time:

In earnest, not much is going for the local equity market. Political stability, which has arguably added some premium to the valuation of the market in the past, is a less convincing proposition nowadays. Global risk appetite for equity is low, more so for emerging markets as developed markets' valuation are also depressed. The only solace would be the fact that most of the selling by the foreign portfolio funds is done. We expect the KLCI to reminisce the 2004-2005 period when the market was directionless most of the time, for the reasons explained below.

### Developed markets' valuation is depressed, global funds will nibble at these markets first before making forays into emerging markets:

As the valuation of developed markets has fallen to relatively "cheap" levels, there are inevitably more attractive compared with emerging markets, from

#### COMPARISON OF MARKET VALUATIONS

	P/E RATIO			P/BV		P/E RATIO		
	CY08	CY09	Historical			CY08	CY09	Historical
<b>ASIA x Japan</b>					<b>US, Europe, Japan</b>			
Taiwan Taiex	10.3	10.1	1.45		Nikkei 225	12.6	11.5	1.12
Hang Seng	11.2	10.0	1.6		Dow Jones	11.0	10.7	2.95
KL Composite	10.7	10.0	1.45		S&P 500	12.2	10.1	1.92
India Sensex 30	11.9	10.0	2.57		DAX	9.7	8.1	1.39
Philippines	11.1	9.9	1.58		CAC 40	8.4	7.7	1.33
China CSI 300	12.1	9.9	2.06		DJ Euro Stoxx 50	8.5	7.7	1.38
S'pore Straits Times	10.5	9.6	1.3		FTSE 100	7.9	7.4	1.48
Korea Kospì	10.3	9.0	1.15					
Thai SET	7.5	7.1	1.09					
Jakarta Composite	9.8	6.0	1.87					

Source : Bloomberg as at 14 Oct

global managers' perspective. The prospective price-earnings ratio (PER) of developed markets is down to almost that of the emerging markets (see table below). The forward PER of DAX and CAC indices, for example, are now in the single digit territory.

**Long time before the KLCI sees the 1,500 again:** It is an accepted notion that local indices will only break their highs as a result of foreign money. On that score, it is unlikely that the Kuala Lumpur Composite Index will see the 14 January 2008 peak of 1524.69 again in the next 2 years. We expect the outlook to be gloomier if the Democrats were to prevail in November. The smart money is banking on Obama to reverse eight years of Bush economic (mis)management. The recipe for an economic cure is already embedded in Clinton's administration way. This entails, among others, judicious spending and a move towards balancing the Federal Budget. Once this is in train, expect the dollar and the capital markets to respond, creating a virtuous cycle which will leave emerging markets, especially Malaysia, out of the loop.

**The KLCI should find its base in the 820 - 950 range in the next 12 months:** We expect the KLCI to establish a base somewhere in the range of 820-950 should there be no marked and sustained improvement in market sentiment. The range would reflect the lower end of the valuation during a bear market phase. Assuming the KLCI were to close the year at 950, it will register a 34.3% loss for the year, which will not be out of line with regional markets.

**Major assumptions:** In deriving our base-case expectation:

- we benchmark the KLCI to the price-to-book value (PBV) multiple during what is generally accepted to be a bear market phase of 2001-2005. We believe that the PBV is a more reliable tool to ascertain the market's base during uncertain times.
- for price-earnings multiple, the market should be mean-reverting during a bear market phase. However, this will not be the case if we were to

Deriving KLCI's Fair Value		
P/BV	High	Low
2000	2.37	1.57
2001	1.63	1.21
2002	1.86	1.40
2003	1.72	1.30
2004	1.82	1.52
2005	1.81	1.63
2006	2.02	1.61
2007	2.46	1.85
2008	2.27	1.43
<b>9-year Average</b>	<b>2.00</b>	<b>1.50</b>

**Bear market phase**  
**Low = 1.21**  
**Average = 1.40**

Source: Bloomberg.

rely on the average low PE that prevailed during 2001-2005, which was 14x. The 9-year mean for the low PER was 13.3x. Applying discounted PER multiple would be misleading and arbitrary.

- the lowest PBV registered during the bearish phase was 1.21x in 2001, which translates into 820 KLCI points. The average PBV during the 5-year was 1.40x which translates into KLCI points of 950.

**The PBV valuation is consistent with the long-term technical perspective:** The recent steep fall of the KLCI has somewhat confirmed that Wave 3 on Elliot wave Count has been terminated and the index is now in Wave 4, which is a bear wave. The main characteristic of Wave 4 is that the correction should see a support near the peak of Wave 1, which was at the 980-1020 level. Wave 4 in the previous cycle lasted for about 1¼ years, i.e. from July 1990 to Sep 1991 with a trading band of 480-640 levels, with the lower band being 25% lower than the upper one. If the experience of the previous cycle is of any assistance, the Wave 4, which commenced in Jan 08, could last until Mar 09 by which time Wave "c" of the wave 4 could have been completed. The downside target is seen at the 810-850 levels. On the flip side, the termination of wave 4 would mark the beginning of wave 5.

**ELLIOT WAVE: Further Consolidation with downside target at 810-850 levels.**



**D. WINNERS IN TROUBLED TIMES**

**i. The qualities we look for**

**Throw the darts or rummage the rubble?** With stocks trading at bargain-basement prices, investors are spoilt for choice. Yet, simply throwing the darts and expect to come out with winners would be a naive approach. It is

true that Mr Buffett has advised investors to be “greedy when others are fearful”. Well, greedy does not mean hasty. Rummage through the rubbles and there will be gems to be found.

**Stocks you cannot ignore:** Valuation alone does not make a compelling buy. We therefore advocate some qualitative yardsticks that we believe are important criteria in choosing the likely winners during these times of trouble. These qualities render the stocks difficult to be ignored by investors looking for outperformance:

- Commendable track record in treating minorities, with strong governance and judicious capital management;
- Focused corporate plans, and the acumen to pursue value-enhancing corporate opportunities.

## ii. Treat minorities right!

**Look for capital management angle in companies that have always been fair to minorities:** Our first screening criteria would have to be on governance. Companies that do not have a culture of governance, and has a history of not treating minorities “right”, are unlikely to “behave” in times of trouble. Avoid these companies.

**There are various circumstances under which minorities may be shortchanged:** Such circumstances include:

- Board tussle among rival factions, which leaves minorities dangling in the middle
- Related party transaction, which although arm’s length, may benefit the substantial shareholder more.
- VGO which is below minority shareholders’ expectations.
- Proposed acquisitions which may not be in line with the company’s focus.
- Inter-company advances and debts.

### EXAMPLES OF OBJECTIONS BY THE MINORITIES WATCHDOG

Company	Proposal	Objection
Maybank	Acquisition of Bank International Indonesia (BII)	Overpriced valuation of BII
Harrisons Holdings (M) Bhd	To be taken private by Bumi Raya International Holdings	The offer price of RM1.45, although revised from RM1.20, was low compared with the net asset per share of RM3.24
Oilcorp	Removal of external auditor	The independence of the proposed external auditor
Maruichi Steel Tube Bhd	Acquisition of Malaysian Marine Merchant Berhad	Pricing issues and the fact that the deal was concluded before an EGM is convened.
FCW Holdings Berhad	-	Consecutive years of absence of the Non-Independent, Non-Executive Chairman from the AGM.
Malton Bhd	-	Consecutive years of absence of the Executive Chairman and Executive director, and their "excessive" remuneration.
E&O Property	To be taken private	Pricing and rationale for the privatisation

Source: Minority Shareholder WatchDog Group press releases

- Frequent restructurings
- Excessive cash holdings

**Unlocking value in a depressed market:** One standard solution to this would be for companies to undertake judicious capital management exercise. Capital management exercises are effectively aimed at:

- optimising capital structure (to achieve a competitive cost of capital, or WACC); and
- enhancing capital efficiency (to improve Return on Invested Capital, ROIC).

Comparing a company's ROIC with its cost of capital (WACC) reveals whether invested capital has been used effectively. *Capital repayment* is used as an efficient method to reward shareholders as it does not attract any tax. For example, DIGI.com had reduced the par value of its shares from RM1 to 10 sen through a series of capital repayment, boosting its ROE in the process. *Special dividends*, on the other, is a popular means to distribute proceeds from the disposal of non-core assets. In this regard, companies trading at very depressed price-to-NTA ratio may seek to mitigate the situation by disposing its non-core assets or its holdings of excess cash. Media Prima, for example made a special dividend of 9 sen per share this year after selling its property in Wangsa Maju.

### iii. Stay the course

**Winners are those undeterred by macroeconomic challenges:** One of the important traits of strong corporate leadership is the ability to ride the storm and emerge intact. A company's business plan that has been endorsed by the board should contain the various macroeconomic scenarios and the prescriptions in response to those scenarios. The bottomline is execution, and this is the part where most corporate shortcomings can be found. Companies without a plan are those that we can afford to ignore (remember Harvey Mackay's: "Those who fail to plan, plan to fail").


**Focused on the core competencies:** We like companies which stay the the course and is focused on its core business competencies. Companies that stray into a new business in times like these are out of our radar screen. It is true that many companies have ventured into a new, unrelated business successfully. For example, UMW has ventured into the upstream oil and gas sector from automotive, Tanjong moved into power from gaming, YTL Corp moved into water from basically an infrastructure construction base. However, these are in essence regulated assets, either by the government, or by the industry itself. Regulated assets provide a an avenue for a company to diversify its earnings base and reduce its volatility.

**Beware of acquisitions:** Cash-heavy companies would appear to be having a field day now, as they are seemingly spoilt for choice when it

comes to acquisition opportunities. We would be wary of companies entering into a related-party-transactions (RPT) acquisitions, specifically when it pertains to valuation. Knocked-down prices alone should not be a basis for entering into an RPT acquisition. Investors need to scrutinize the RPT deal and penetrate the frame of mind of the respective buyers and vendors for ulterior motives.

### iii. Who dares win: Stock Selection

**Familiar names:** Our top 10 picks are a combination of familiar big cap names across various industries. The list of likely winners include TM, Tenaga, Proton, Public Bank, Dialog, Parkson, IOI Corp, UMW, Lion Industries and AEON. The investment considerations include factors discussed in the aforementioned and are summarized in the following tables. We also include a list of stocks, including small and mid-caps which are on our radar screen (see Appendix), and are deemed attractive at current levels. There are values in all the names at current price levels, but timing issues given volatile market conditions could determine entry points.

**Leadership matters:** Regardless of the industry, we believe that in trying times, corporate leadership matters, and each company charts its own route out of the storm. These are companies that dare to stay rooted to their values and missions. 

#### MIDF's Selection

Stock	Price	FV	Market	EPS		EPS Growth		PER		P/Book	Div Yld	ROE
	@23 Oct		Cap.	(sen)		(%)		(x)		(x)	(%)	(%)
	(RM)	(RM)	(RM)	FY09F	FY10F	FY09F	FY10F	FY09F	FY10F	FY09F		
TM	3.38	3.80	12,020.1	25.8	27.8	12.7%	7.7%	13.10	12.16	0.6	6.9%	6.0%
Proton	2.36	4.15	1,351.1	41.0	62.6	11.1%	52.7%	5.76	3.77	0.2	2.7%	2.0%
Tenaga	6.45	7.80	28,175.2	52.0	68.8	-19.4%	32.3%	12.40	9.38	2.0	3.2%	8.9%
Public Bank	8.75	10.75	30,904.1	78.1	81.7	2.0%	4.6%	11.20	10.71	3.2	8.9%	26.0%
Parkson	3.38	5.50	3,793.3	27.5	34.3	-4.5%	24.7%	12.29	9.85	2.5	2.8%	22.7%
UMW	5.65	6.71	6,156.8	61.0	69.5	8.9%	13.9%	9.26	8.13	0.9	5.6%	16.3%
Dialog	0.76	1.26	1,074.0	11.5	15.0	47.8%	29.9%	6.59	5.07	2.3	5.7%	26.2%
AEON Corp	4.06	4.90	1,432.1	37.5	40.6	18.7%	8.3%	10.83	10.00	0.8	2.4%	13.0%
IOI Corp	3.02	3.90	19,288.4	28.0	31.0	-12.5%	10.7%	10.79	9.74	2.0	4.6%	22.0%
Lion Ind.	0.55	1.08	524.0	68.5	48.4	-6.2%	-29.4%	0.80	1.14	0.1	2.4%	15.5%

Source: MIDF Research, Bloomberg

STOCK	REMARKS
Telekom	<ul style="list-style-type: none"> <li>• A good <b>dividend</b> play as TM has a dividend policy of a minimum RM700m (19.6 sen) or 90% of net profit, whichever is higher. This translates into a minimum net yield of 5.8% at current price.</li> <li>• <b>Commendable earnings growth</b> with broadband subscribers having expanded 37%y-o-y to 1.5m in 2Q08, resulting in stronger internet revenue of RM695m from RM557m in 1H08.</li> <li>• <b>Undemanding valuation.</b> Fairly valued at RM3.80, suggesting a potential upside of 13% from current level. Any weakness in the share price would provide opportunity to accumulate.</li> </ul>
Proton	<ul style="list-style-type: none"> <li>• <b>Limited downside to share price.</b> The all time low for Proton share price was RM1.98 on 1 Sept 1998, during the height of the Asian financial crisis, where the KLCI was at 262.7 level.</li> <li>• <b>Improving.</b> Proton is on the right track in terms of quality enhancement and new product launches – a new MPV, Satria Neo GTI and Waja replacement are in the pipeline.</li> <li>• <b>A turnaround play.</b> We are expecting a turnaround in its financial performance especially with the strong take-up of its Saga and Pesona SE, and its ventures into new overseas market .</li> <li>• <b>Cheap valuation.</b> At RM2.46 per share, we view Proton as a Buy with fair valuation of RM4.15 or 0.4x estimated book value of RM10.41 per share.</li> </ul>
Tenaga	<ul style="list-style-type: none"> <li>• <b>Trading at a 17% discount to its fair valuation.</b> Based on DCF, we value Tenaga at RM7.80.</li> <li>• <b>Easing in coal prices to provide relief for margin.</b> The average coal price secured for 1Q09 was US\$113.0/MT. We are expecting a further decline in coal costs for the remainder of FY09.</li> <li>• <b>Tariff hike in July.</b> The government will review gas prices in July 09 and TNB is entitled for tariff adjustment vis-à-vis the movement of gas prices. Higher potential tariff and lower average fuel costs would help to compensate a flattish demand growth.</li> </ul>
Public Bank	<ul style="list-style-type: none"> <li>• Our top pick among banks for its strong fundamentals and sound management.</li> <li>• <b>Dividend yield</b> the highest among banks.</li> <li>• <b>Solid balance sheet.</b> Strong CAR at 7.4% (June 07 : 7.7%) while RWCR was at 13.2% (June:13.6%).</li> <li>• <b>High asset quality.</b> The group's NPL was at 0.98%, well below the industry average of 2.5% (3-mth classification); displaying its prudent management.</li> <li>• <b>RM10.75 fair value</b> based on 14x PER on FY08 EPS forecast of 76.6 sen.</li> </ul>
Parkson	<ul style="list-style-type: none"> <li>• <b>Strong foothold in China's huge retail market,</b> with 41 retail outlets in 26 major cities in China, plus 31 in Malaysia and 3 in Vietnam. Main catalysts would be the earnings potential from China and Vietnam with estimated growth of 15% and 20% for '09 respectively.</li> <li>• <b>Trading at undemanding multiple.</b> Currently trading at 13.1x PER based on FY09 EPS forecast of 27.5 sen, as compared to the average 20x of its Hong Kong-listed subsidiary, Parkson Retail Group (PRG) and is at par with the domestic retail sector.</li> <li>• <b>Valuation premium deserving.</b> Parkson deserves a valuation premium given the sheer size and tremendous growth opportunity in China's retail market.</li> </ul>

STOCKS	REMARKS
UMW	<ul style="list-style-type: none"> <li>• <b>2-pronged assault on car sales.</b> Toyota and Perodua are market leaders in their respective segment.</li> <li>• <b>2 new vehicles.</b> The group has allocated about RM200m budget for outlet expansion plans and the introduction of 2 new models namely the Hybrid Camry and Prius by 2009.</li> <li>• <b>Growing oil &amp; gas contribution.</b> 80% of revenue is contributed by automotive business, while O&amp;G contributes 5%. Growth is expected from its overseas ventures.</li> <li>• O&amp;G division will be kept <b>busy</b> with the Naga 2 Jack-up drilling rig and Zhoungyou BSS contracts till 2011. A fabrication yard in Lumut to be jointly owned with a local partner, is expected to take off in 3 years.</li> </ul>
Dialog	<ul style="list-style-type: none"> <li>• <b>Upbeat fundamentals and strong order book.</b> The company displayed strong earnings with FY08 revenue and net profit increasing 67.2% and 58.1% y-o-y.</li> <li>• <b>Favourable earnings upside.</b> We expect its future earnings would be strongly dependent on the successfully secure and execution of these projects namely the ( i) Phase II Langsat Terminal, ( ii) Kimanis Terminal EPCC contract (RM1.6b), and (iii) expansion of the Kertih terminal.</li> <li>• <b>RM1.2b order book.</b> Orderbook to date stands at RM1.2b and the company has tendered RM3.1b worth of projects.</li> <li>• <b>Domestic O&amp;G sector to remain vibrant.</b> We do not foresee significant downside to the sector despite the softer crude oil prices. Production start at Kikeh and the development of Kimanis Terminal would attest to the buoyant sectoral outlook.</li> </ul>
Aeon Co.	<ul style="list-style-type: none"> <li>• <b>Enviably position in domestic retail market</b> with huge loyal patrons and its strong position in the middle-income retail segment with 19 Jusco stores in 12 major cities nationwide.</li> <li>• <b>Sound fundamentals.</b> Expect revenue for FY08 and FY09 to grow by 12.7% and 13.6% respectively. Healthy cash flow with a 5-year average net operating inflow of RM225.4m/year.</li> <li>• <b>Undemanding trading multiple</b> at the lower end of its 3-year PE band of 9x and 18x range. We fairly value AEON at RM4.90, based on 13x PER of FY09 EPS forecast of 37.5 sen.</li> </ul>
IOI Corp	<ul style="list-style-type: none"> <li>• <b>Still the one.</b> Perceived as a solid plantation company with sound management team and an efficient operations (high FFB yield &amp; oil extraction rate).</li> <li>• <b>Expanding landbank.</b> Recent acquisitions –( i) 33% stake in PT Bumitama Gunajaya Agro which has 35,300 ha of planted area and 64,500 ha of unplanted area; (ii) 67% stake in several companies which have 52,700 ha of land available for planting.</li> <li>• <b>Ripe for picking.</b> For the past 5 financial years, IOI Corp traded within a PER band of 10.4x - 42.0x and currently trades at just 11.0x FY09 EPS of 28.0 sen. Downside is fairly limited.</li> </ul>
Lion Industries	<ul style="list-style-type: none"> <li>• <b>Less than 1x PER!!</b> This is one grossly undervalued stock and seems irresistible especially in view of its improving earnings visibility and the long term growth potential. Despite the softer steel prices, global demand is still strong in view of the acute shortage of steel in the market.</li> <li>• <b>Lucrative new contract.</b> The group has obtained a licence from Vietnam government in a JV with top shipbuilder Vinashin to build a US\$9.8b steel mill with construction starting in 1Q09.</li> <li>• <b>Earnings to contract in 2009....</b> FY08 EPS jumped 221% to RM1.21 from 37.7 sen due to higher steel prices, but we expect earnings to decline -50% in FY09.</li> <li>• <b>.... but valuation is still dirt cheap.</b> Even with 50% fall in EPS, PER is still just 1.3x 2009 earnings. For the past 3 financial years, it traded between a PER band of 1.1x and 7.3x. Fairly valued at RM1.08, a 43% upside potential from current level.</li> </ul>

## IN THE MIDF RADAR : BIG-CAP INVESTMENT STATISTICS

No	Stock	Price	Market Cap	EPS		EPS Growth		PER		Price/	Div. Yld	ROE
		@ 23 Oct		(sen)		(% )		(x)		Book	(%)	(%)
		(RM)	(RM'm)	FY09F	FY10F	FY09F	FY10F	FY09F	FY10F	(x)	FY08E	FY08E
1	MISC	8.20	30,502.6	68.1	74.5	8.6%	9.5%	12.0	11.0	1.54	4.3%	12.0%
2	Malayan Banking	5.15	25,137.9	70.6	72.4	5.7%	2.6%	7.3	7.1	1.30	8.4%	16.1%
3	TM Int'l	4.90	18,391.7	48.5	55.7	13.6%	14.9%	10.1	8.8	1.57	2.8%	13.3%
4	DiGi.Com	22.10	16,575.0	161.4	176.4	5.1%	9.3%	13.7	12.5	7.18	6.8%	64.5%
5	BAT	41.25	11,778.1	277.3	283.1	2.9%	2.1%	14.9	14.6	21.71	7.5%	178.4%
6	PPB Group	8.20	9,721.1	90.3	91.9	5.9%	1.7%	9.1	8.9	0.86	7.4%	9.4%
7	YTL Power	1.71	9,775.5	16.6	20.3	8.5%	22.6%	10.3	8.4	1.41	7.4%	15.0%
8	YTL Corporation	5.85	9,553.4	56.1	58.9	8.5%	5.0%	10.4	9.9	1.09	3.7%	9.9%
9	RHB Capital	3.02	6,503.5	47.2	50.4	8.8%	6.8%	6.4	6.0	0.90	5.3%	12.9%
10	Nestle	28.25	6,624.6	147.7	156.7	7.8%	6.1%	19.1	18.0	13.65	6.2%	48.5%
11	Petronas Dagang	6.60	6,556.8	83.0	80.3	9.6%	-3.3%	8.0	8.2	1.58	6.7%	16.8%
12	AMMB Holdings	2.08	5,663.8	32.3	35.4	10.2%	9.5%	6.4	5.9	0.79	3.6%	11.0%
13	MMC Corp	1.88	5,724.7	18.9	24.7	-3.1%	30.8%	9.9	7.6	0.97	2.8%	10.7%
14	Malaysian Airline	3.06	5,113.3	27.1	36.4	54.9%	34.2%	11.3	8.4	1.25	0.6%	9.7%
15	Sarawak Energy	2.18	3,327.6	21.5	24.0	11.4%	11.8%	10.1	9.1	1.22	2.0%	11.2%
16	Gamuda	1.60	3,209.9	22.7	24.3	14.1%	6.9%	7.0	6.6	1.05	13.1%	13.6%
17	AirAsia	1.17	2,777.7	9.9	11.8	41.4%	19.4%	11.8	9.9	1.22	0.0%	8.6%
18	Oriental Holdings	5.00	2,585.0	-	-	-	-	-	-	0.71	-	-
19	Malaysia Airports	2.23	2,453.0	29.0	30.7	12.0%	5.9%	7.7	7.3	0.80	6.3%	9.3%
20	Lafarge M-Cement	2.71	2,302.7	39.0	42.2	13.7%	8.3%	6.9	6.4	0.79	7.3%	9.9%

Source: MIDF Research, Bloomberg, IBES

\* Big cap is defined as those with market cap &gt; RM2.5b, small cap &lt;RM500m. Mid-cap is in between.

## IN THE MIDF RADAR : SMALL AND MID-CAP INVESTMENT STATISTICS

No	Stock	Price	Market	EPS		EPS Growth		PER		Price/	Div. Yld	ROE
		@ 23 Oct	cap	(sen)		(% )		(x)		Book	(%)	(%)
		(RM)	(RM'm)	FY09F	FY10F	FY09F	FY10F	FY09F	FY10F	(x)		
1	KFC	6.55	1,298.7	59.10	62.61	5.0%	5.9%	11.2	10.5	2.02	3.3%	16.4%
2	Media Prima	1.23	1,050.2	15.90	18.43	4.6%	15.9%	8.2	7.1	1.86	8.1%	23.7%
3	Pos Malaysia	1.82	977.4	20.30	24.27	4.6%	19.6%	9.0	7.5	1.14	6.0%	9.0%
4	KPJ Healthcare	2.61	545.9	43.00	48.50	15.0%	12.8%	6.6	5.9	0.98	6.7%	15.7%
5	MRCB	0.60	540.0	6.40	7.70	52.4%	20.3%	9.9	8.2	0.75	1.4%	6.2%
6	MBM Resources	2.02	489.0	53.60	57.89	6.1%	8.0%	3.8	3.5	0.59	8.0%	14.77
7	Kinsteel	0.44	407.9	22.80	27.13	-18.6%	19.0%	1.9	1.6	0.11	8.2%	29.49
8	Hock Seng Lee	0.60	349.6	8.50	10.27	14.9%	20.9%	7.1	5.8	1.46	5.2%	18.15
9	Aeon Credit	2.74	328.8	46.50	55.17	25.7%	18.6%	5.9	5.0	1.67	4.4%	21.92
10	Dayang Enterp.	0.86	301.0	17.00	20.30	21.4%	19.4%	5.0	4.2	0.98	11.7%	17.10

Source: MIDF Research, Bloomberg, IBES

## MIDF EQUITY MARKETS

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### MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

#### STOCK RECOMMENDATIONS

BUY	Total return is expected to be > 5% compared with that of an assigned benchmark over the next 12 months.
TRADING BUY	Stock price is expected to rise within 3-months after an investment rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -5% and +5% compared with that of an assigned benchmark over the next 12 months.
SELL	Total return is expected to be < 5% compared with that of an assigned benchmark over the next 12 months.
TRADING SELL	Stock price is expected to fall within 3-months after an investment rating has been assigned due to negative newsflow.

#### SECTOR RECOMMENDATIONS

OVERWEIGHT	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.
UNDERWEIGHT	The sector is expected to underperform the overall market over the next 12 months.



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