Corporate Update | Friday, 17 February 2023

UMW Holdings Berhad

(4588 | UMWH MK) Consumer Products & Services | Automotive & Parts

***Maintain* BUY**

Strategic growth in aerospace

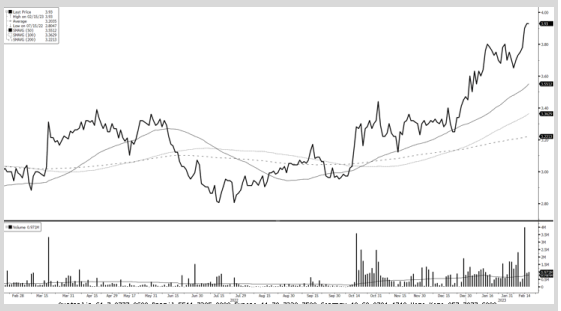
***Unchanged* Target Price: RM5.00**

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**
- **Reaffirm BUY at unchanged TP of RM5.00**

RETURN STATISTICS	
Price @ 16th Feb. 2023 (RM)	3.93
Expected share price return (%)	+27.2
Expected dividend yield (%)	+3.5
Expected total return (%)	**+30.7**

SHARE PRICE CHART



Share price performance (%)	Absolute	Relative
1 month	4.0	5.0
3 months	13.3	14.9
12 months	27.2	37.5

KEY STATISTICS	
FBM KLCI	1,484.26
Syariah compliant	Yes
F4BGM Index	N/A
ESG Grading Band (Star rating)	N/A
Issue shares (m)	1168.29
Estimated free float (%)	28.73
Market Capitalisation (RM'm)	4,591.40
52-wk price range	RM2.77 - RM4.04
Beta vs FBM KLCI (x)	0.86
Monthly velocity (%)	0.00
Monthly volatility (%)	13.91
3-mth average daily volume (m)	0.79
3-mth average daily value (RM'm)	2.86
Top Shareholders (%)	
Amanah Saham Nasional Bhd	55.16
Employees Provident Fund Board	10.51
Kumpulan Wang Persaraan Diperbadan	9.12

We recently visited UMW's aerospace plant in Serendah. The visit was generously hosted by UMW Aerospace's head of plant, Mr Rahul Kashyap and UMW's investor relations team. Several key highlights from the visit:

Approaching an inflexion point. UMWA incurred losses in FY20-22 as demand has been weak in the past three years due to the pandemic but is finally rebounding. We estimate UMWA incurred net losses of -RM35m in FY21, but this should have narrowed slightly in FY22. We gather that the group managed to break-even in 4Q22 and is expected to return to profits in FY23. The plant is now running at 60% utilization (which is already above break-even levels) and is expected to improve further. Management is guiding for demand to exceed pre-pandemic levels this year as backlog production for Boeing and Airbus resumes amid the recovery in global air travel. Additionally, FY22 demand was impacted by disruptions in Boeing's B787 production due to fuselage manufacturing quality issues, which had been resolved since 3Q22.

Potential margin expansion. UMWA will be localising rear fan cases in the near future (currently it is producing the front case portion). This will serve to reduce cost, hence improve margins once production commences. Currently, rear fan cases are sourced from RR's existing American supplier. A new facility to house production of rear fan cases is already underway and is expected to be completed in Aug-23. There will be trial runs before the facility officially commences production in FY25. Details on capex and returns are not forthcoming yet at this juncture.

Opens the door for new opportunities: Manufacturing of rear fan cases will require UMWA to acquire electro-chemical milling technologies, which will be available in the new facility. This is a unique capability that is lacking in ASEAN. Current electro-chemical milling processes in the Asian aerospace industry is dominated by South Korea's LAKWOO Industry Co. Ltd. and China's SinoGuide. Chemical milling capability will allow UMWA to fill in this gap and expand its product range beyond fan cases to include other advanced aero components such as jet engine after burners and aircraft wing skin panels.

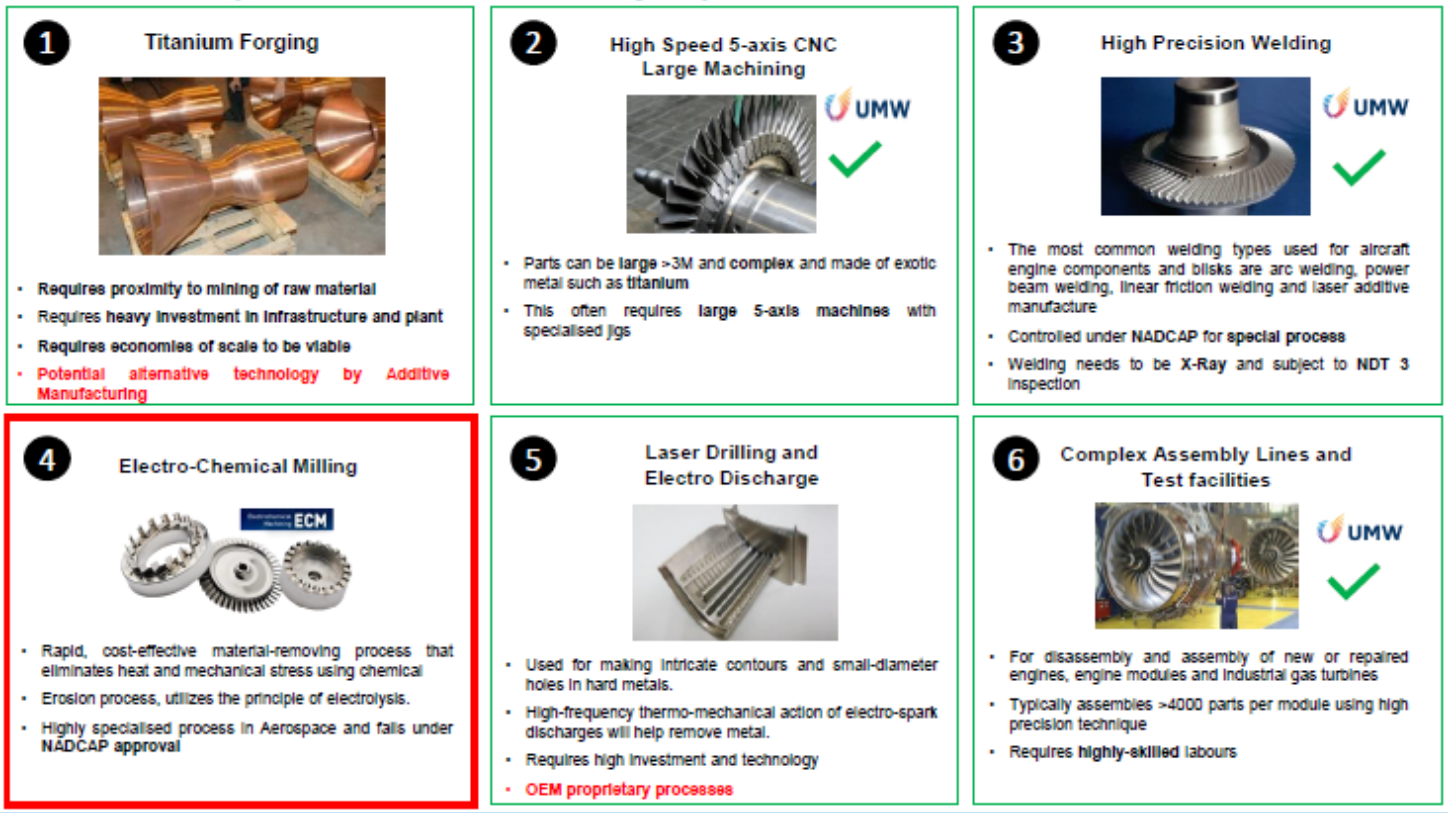
Analyst:
Hafriz Hezry
hafriz.hezry@midf.com.my
03-2173 8392

INVESTMENT STATISTICS

FYE Dec	FY19	FY20	FY21	FY22F	FY23F
Revenue (RM'm)	11,739.1	9,554.6	11,060.8	12,629.4	12,242.4
EBIT (RM'm)	332.6	257.7	274.2	649.0	522.7
Pre-tax Profit (RM'm)	754.8	400.7	482.8	852.1	772.5
Core net profit (RM'm)	266.3	240.9	196.8	393.5	397.4
FD EPS (sen)	22.8	20.6	16.8	33.7	34.0
EPS growth (%)	(22.1)	(9.5)	(18.3)	99.9	1.0
PER (x)	17.2	19.1	23.3	11.7	11.6
Net Dividend (sen)	6.0	4.0	5.8	13.5	13.6
Net Dividend Yield (%)	1.5	1.0	1.5	3.4	3.5

Source: Company, MIDFR

Exhibit 1: Key capabilities in Tier-1 complex machining; UMW has 3 (and soon 4) of 6 capabilities



Source: Company, MIDFR

Exhibit 2: Chemical Milling Process and Parts



Source: Company, MIDFR

Exhibit 3: Titanium aero engine rear case



Source: Company, MIDFR

Exhibit 4: Jet engine after burner



Exhibit 5: Aircraft wing skin panel



Source: Company, MIDFR

Background on UMW Aerospace. UMW Aerospace (UMWA) was inducted in the UMW group in 2015. It produces aircraft engine fan cases for Rolls Royce (RR) for the Trent 1000 (used exclusively for the A330 NEO) and Trent 7000 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 1st Trent 1000 fan case in 2017 and saw its maiden profit in 2019. Meanwhile, production of the Trent 7000 fan cases started in 2020.

Production facility. 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 are titanium - fluctuation in raw material prices are ultimately passed through to the customer. In terms of forex exposure, UMWA attains a natural hedge as both raw material cost and revenue are denominated in USD.

Exhibit 6: Production cell layout

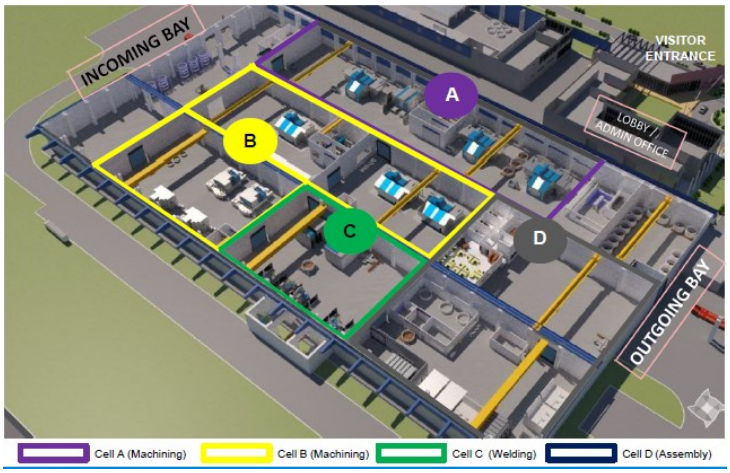


Exhibit 7: Front case machining

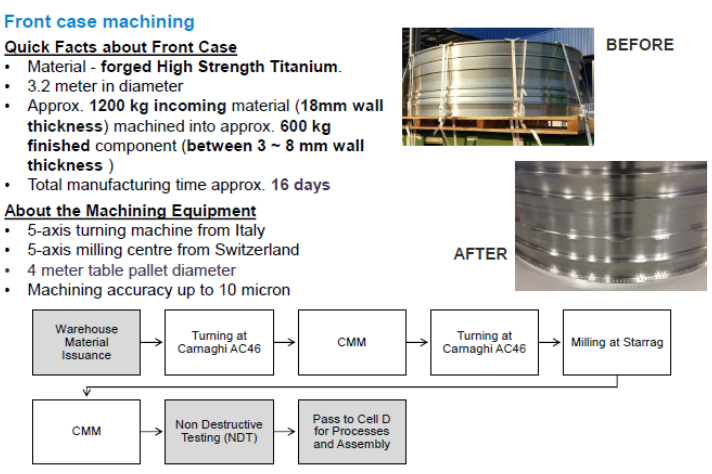


Exhibit 8: Inner ring machining

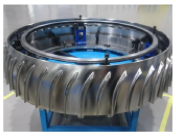
Inner ring machining

Quick Facts about Inner Ring
- Material - **forged High Strength Titanium**
- 1.5 meter in diameter
- Approx. 250 kg as billet
- Approx. 70 kg as finished component
- Manufactured in approx. **15 days**



BEFORE

About the Machining Equipment
- 5-axis turning machine from Italy
- 5-axis milling centre from Japan
- 2 meter table pallet diameter
- Machining accuracy up to 10 micron



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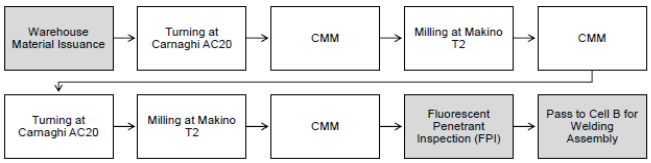
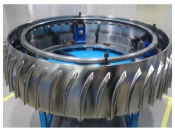


Exhibit 9: OGV welding

Outlet Guide Vanes (OGV) welding

Quick Facts on the OGV Welding Process
- Titanium TIG welding used to assemble 44 OGV Vanes to the machined Inner Ring
- Highly skilled, manual welding operation; minimum hiring requirement of 6G Welding certification
- All the welders MUST be **able to weld with BOTH their left and right hands**
- In order to qualify as Certified Welder, they typically undertake an approx. **6 months intensive training and 8 qualification assessment steps**
- Standard welding rate at 4 vanes per shift
- Total Process (end to end) takes approx. **22 days**



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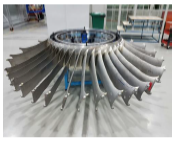

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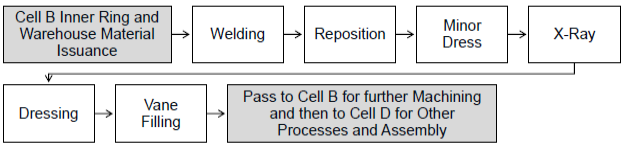


Exhibit 10: OGV dressing process



About OGV Dressing Process
- The goal of dressing after welding is to make the **surface flush**
- **Manually** performed with 2 grades dressing tools
- The process is performed in a controlled environment – downdraught booths ensure the safety of operators and dust free work



Before Dressing



After Dressing

Exhibit 11: OGV assy machining

Turning operation on Carnaghi AC36

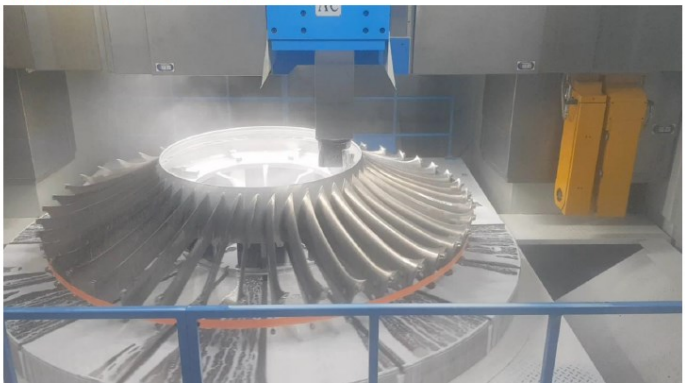


Exhibit 12: Auto grit blast & clean room bonding

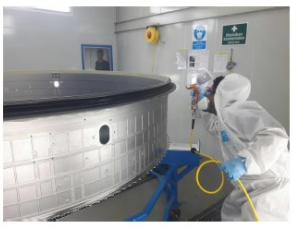


About Auto Grit Blast
- Grit Blasting is a **surface preparation process** done prior to painting and bonding of noise attenuating panels to the fan case
- Shoots **aluminum oxide** grit finer than sand at a pressure of 50lb PSI is used to roughen up surface
- Chamber capacity of one Fan Case up to 3.5m.
- Pressure chamber approved by DOSH.
- Made in Malaysia equipment (Abrasive Engineering)

About Clean Room
- **Class 8** Clean Room
- Provides clean and controlled environment for bonding i.e. >95% humidity, 23 deg C room temperature, and up to **100,000 airborne particle count**
- Can accommodate up to 4 Fan Cases at one time



Exhibit 13: Painting and bonding oven



About Painting Process
- Paint is applied as **surface preparation** prior to bonding and also meant for corrosion protection
- Chamber capacity of one fan case up to 3.5m
- Equipment Made in Malaysia

About Bonding Oven
- Bonding oven is utilised for the **curing of paint**
- Max temperature up to 210 deg C
- Capacity of one fan case up to 3.5m
- Compliance with AMS2750E
- Equipment Made in Malaysia



Source: Company, MIDFR

Exhibit 14: Inspections

All parts go through 100% inspection as they move from one process to another.

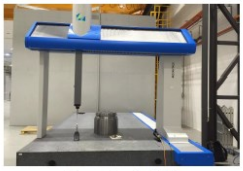
Primarily, there are 3 types of inspections:

- Visual
- Dimensional
- Non-Destructive Testing (NDT)

All inspectors must go through 5-Step Training Packs and undergo a period of supervised works before qualified to do own inspection.



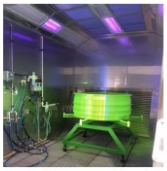
Visual



Dimensional - CMM



NDT - X-Ray (digital)



NDT - Fluorescent Penetrant Inspection

Exhibit 15: Final assembly

This is where all comes together; Front Case Assembly, OGV Assembly, Mount Ring Assembly and Rear Case Assembly are joined into a Fan Case Kit.

Quick Facts about Fan Case Kitting (Final Assembly) Process

- End to end process takes approx. **5 days.**
- Maximum rate of 5 units per week or 250 units per year (by 2020).
- Final delivery weight of approx. 800kg.
- Final inspection gate prior to delivery to customer



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) employing some 25,000 highly skilled workers.

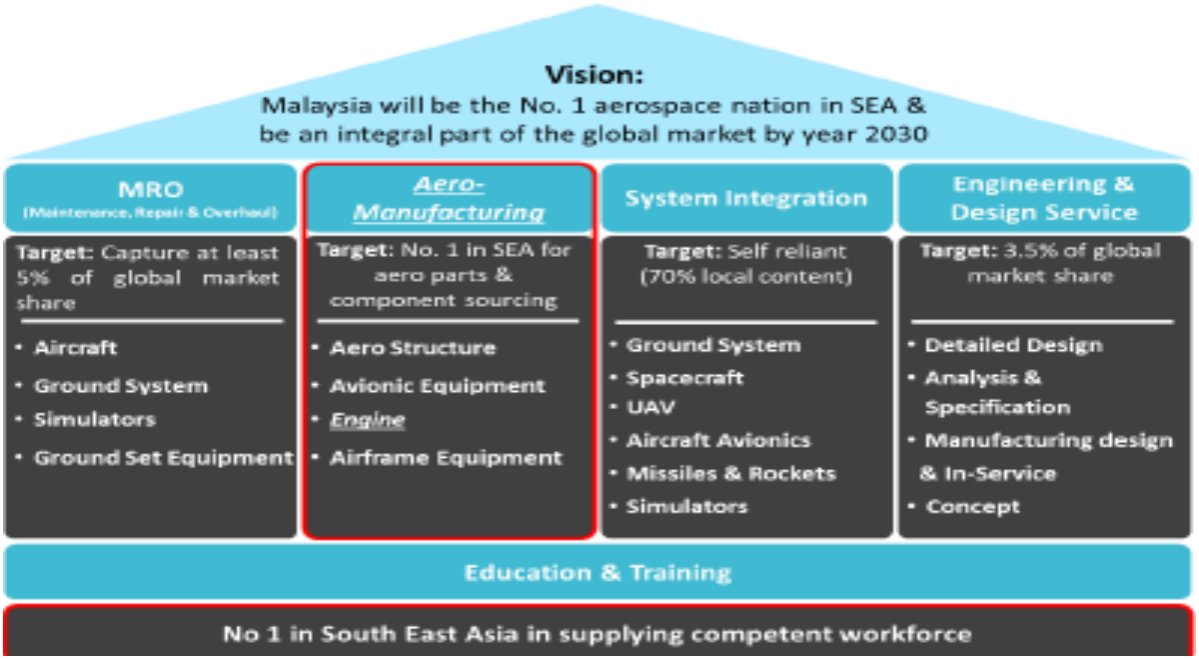
Exhibit 16: Global aero engine tiering



*from Rolls Royce annual report for commercial turbofan

Source: Company, MIDFR

Exhibit 17: Malaysia aerospace industry vision



Source: MITI, MIDFR

Exhibit 18: Aerospace ecosystem in Malaysia



Source: Company, MIDFR

Recommendation. We re-affirm our **BUY** call at unchanged SOP-derived **TP** to **RM5.00.** 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 has grown to RM1.13b (RM0.97/share or 25% of market cap) as of 3QFY22 which underpins a higher dividend payout and M&A potential. Valuations are undemanding at just 11.6x FY23F PER, at 35% discount to historical mean. Key risk to our call is a significant weakening of the Ringgit, further lockdowns and a worse than expected global chip shortage situation.

Exhibit 19: UMW Sum-of-Parts Valuation

Segments	FY23F adjusted net profit (RMm)	Valuation	Multiple (x)	Value (RMm)	Comments
Automotive	436	PER	11	4,796	
Equipment	56	PER	11	614	
Serendah land		RNAV		353	RNAV of Serendah land (500acres@RM16psf) (net of debt)
Aerospace		DCF		85	Equity value of 25-year Rolls Royce contract (WACC: 8.7%)
Total value				**5,848**	
No of shares (m)				1,168	
Fair value (RM)				**5.00**	

Source: Company, MIDFR

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
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.
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