

Notion VTEC

(RM2.74 NVB MK)

Buy

Target Price: RM3.74

Progress of new Klang plant on track

TECHNOLOGY

• **A few words from management**

We hosted a corporate luncheon recently for Notion VTEC which was attended by a good crowd of buy-side analysts and fund managers. Management gave some good insights and outlook for the HDD business which will be the main growth driver in the coming years.

• **Notion not likely to go ahead with private placement**

We understand from management that due to pricing issues, debt financing will be used instead. Nonetheless, the 1-for-5 free warrants exercise will proceed as planned.

• **HDD future is bright and resilient**

Management believes the 2.5" HDD segment is where growth is due to (1) the explosive growth of data, (2) high growth of external HDDs and (3) high growth of mobile PCs vs. desktop PCs.

• **Progress of new Klang plant on track**

By year end, Notion expects capacity for the 2.5" HDD components (base plates, spindle motor hubs) to reach 2m/mth under its 1st phase. Notion currently produces 400-500k/mth for Samsung. Subsequently, the 2nd and 3rd phases will proceed with each phase requiring about 6 months each for total capacity to reach 4m/mth and eventually 7m/mth.

Management hinted that due to political uncertainties in Thailand and the need to oversee the new plant in Klang, any major expansion in the Thai plant will likely be completed only sometime in 2011 whereby Notion is looking to expand floor space from 25k to 225k sq ft.

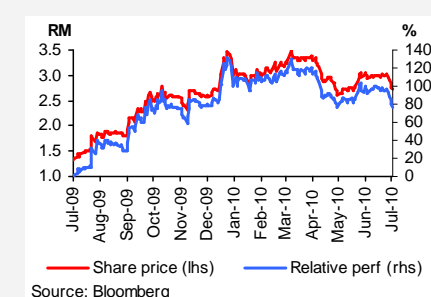
• **Outlook for the next 2 quarters**

Orders for HDD business have been very positive so far, though there was a slowdown in Jun, and it is difficult to tell if the slowdown is simply temporary. Also, Notion is working to bring down rejection rates in its new Klang plant from 10-12% to 5%. In the interim, margins may be affected.

• **Maintain BUY, TP revised to RM3.74**

We raise FY10-12 EPS forecasts by 3-5% to account for (1) the aborted private placement, (2) higher interest costs, and (3) dilution from the in-the-money warrants. Hence, we revise our TP from RM3.63 to RM3.74 based on an unchanged PE multiple of 9x on mid FY10/11 earnings. We are positive that progress in the new Klang plant is on track, and believe once quality issues are ironed out, margins should improve and earnings growth should accelerate.

Share Price Chart



Price Performance

Price (RM) 2.74
 52-week Range (RM) 1.33 – 3.49
 Avg Daily Volume ('000) 691

	1M	3M	6M
Absolute (%)	(9.6)	(16.0)	(12.2)
Relative (%)	(10.6)	(16.3)	(15.4)

Key Data

Market Cap (RM m) 424
 Issued Shares (m) 155

Major Shareholders

Shareholder	%
Choo Wing Hong	13.1
Choo Wing Onn	9.7
Thoo Chow Fah	9.4
Nikon Corp	9.0

Balance Sheet Highlights (RM m)

(@ 30.09.2010) (performance indicator's annualised)

Total Assets	476
Total Liabilities	224
Total Debt (Gross)	186
Shareholders' Equity	251
Return on Assets (%)	11.0
Return on Equity (%)	20.8
Net Cash / Share (RM)	-

Debt/Equity (x)	0.7
Interest Cover (x)	8.9

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Financial summary					
FYE 30 Sep	2008	2009	2010F	2011F	2012F
Revenue (RM m)	146.1	172.7	258.8	390.2	508.4
EBITDA (RM m)	55.6	63.9	90.9	136.6	171.3
Net profit (RM m)	32.9	35.9	52.2	77.2	102.8
Adj EPS (sen)	23.4	25.5	33.6	49.7	66.1
ECM / Consensus (%)			101.4	105.5	106.2
EPS growth (%)	23.7	9.0	32.4	47.9	33.1
P/E (x)	11.7	10.7	8.1	5.5	4.1
Net DPS (sen)	5.0	5.0	6.8	10.0	13.3
Dividend yield (%)	1.8	1.8	2.5	3.6	4.9
BVPS (RM)	0.88	1.06	1.62	2.02	2.56
P/BV (x)	3.1	2.6	1.7	1.4	1.1

A few words from management

We hosted a corporate luncheon recently for Notion VTEC which was attended by a good crowd of buy-side analysts and fund managers. Representing Notion VTEC (Notion) management was Mr Thoo Chow Fah, Executive Chairman, who gave some good insights and outlook for the hard disk drive (HDD) business which he foresees will be its main growth driver in the coming years.

Notion not likely to go ahead with private placement

Recall in April that Notion had announced a private placement exercise to fund the capex for its new third plant in Klang that will drive earnings going forward. However, we understand from management that the private placement exercise will not likely go ahead which we believe is due to pricing issues. Instead, Notion will use debt financing and we understand Notion has the support of banks and therefore should have sufficient credit lines to fund its expansion.

Debt to fund new plant in Klang

Nonetheless, management said the 1-for-5 free warrants exercise will proceed as planned. The exercise price for the free warrants has been fixed at RM2.55 each, representing 14.8% discount over the 5-day volume weighted average price up to 15 Jul. Notion's shares will go ex-warrant on 30 Jul while the entitlement date for the free warrants is 3 Aug.

Free warrants at about 15% discount

HDD future is bright and resilient

Management saw the opportunity to manufacture 2.5" HDD components based on overall trends that 2.5" HDD shipments are expected to overtake 3.5" HDDs, given (1) explosive growth of data, (2) high growth of external HDDs and (3) high growth of mobile PCs vs. desktop PCs. Mobile PCs use 2.5" HDDs for storage while desktop PCs use 3.5" HDDs. Historically, 90% of Notion's HDD business involved 3.5" HDD components.

Shift to 2.5" HDD components to ride strong growth trend

Management also described the HDD business as one which is resilient and less subject to economic fluctuations compared to the Camera business. Management described its past experience when the global financial crisis was at its peak in late 2008 when orders for the SLR components (Camera business) fell by 70% before recovering in 2QCY09. In contrast, worldwide shipments of HDDs actually grew 11% from 2008 to 2009.

HDD a more resilient business compared to Camera

Progress of new Klang plant on track

The 1st phase of the new plant in Klang requiring RM80m in capex will be funded by bank borrowings and is on track to completion by year end. By then, Notion expects capacity for the 2.5" HDD components (base plates, spindle motor hubs) to reach 2m/mth with ASP of about US\$1.60 each (base plate: US\$1.20, spindle motor hub: US\$0.40). To handle the increase in capacity, management expects its labour to increase from 2k to 3k by 1QCY10.

1st phase in Klang on track to reach 2m/mth capacity by year end

Subsequently, the 2nd and 3rd phases will proceed with each phase requiring about 6 months each for total capacity to reach 4m/mth and eventually 7m/mth. Management has guided for the 2nd and 3rd phase to require total capex of RM70m, which will likely use a combination of internal funding and bank borrowings. Management however cautioned that the targets for the 2nd and 3rd phase and the associated capex will also depend on customers' needs to prevent underutilization of plant capacity.

2nd and 3rd phase will be funded by combination of internal funds and debt

As of this month, Notion is producing 400-500k/mth for Samsung. Of the total 7m/mth projected capacity, management foresees eventually producing 2m/mth for Samsung and the remaining 5m/mth to be divided among the other customers (Alphana, Western Digital and Hitachi). Orders for Samsung will be filled first before the requirements of the other customers.

Samsung as main customer

Proceeding with caution in Thailand

Management hinted that due to political uncertainties in Thailand and the need to oversee the new plant in Klang, any major expansion in the Thai plant will likely be completed only somewhere in 2011 where Notion intends to expand floor space from 25k to 225k sq ft. Notion's Thai plant is mainly used to produce SLR components for Nikon as its main customer. Nonetheless, management expects the Camera business to register high single digit growth.

Outlook for the next 2 quarters

According to management, orders for its HDD business have been very positive so far this year, though there was somewhat of a slowdown in Jun, and it is difficult to tell if the Jun slowdown is simply temporary. Nonetheless, ASPs have been stable due to shortage issues.

Besides that, as Notion is new to the 2.5" HDD business, management cautioned that there may be quality issues that need to be ironed out and we believe this may have some impact on margins. Nonetheless, Notion has managed to drastically reduce rejection rates from 20-30% during the early stages of the 1st phase to current levels of 10-12%.

Management is targeting rejection rates to stabilize at 5% in the coming quarters. Once the quality issues are ironed out, we expect margins should improve and earnings growth should accelerate.

Strong orders but Jun saw a slowdown

Quality issues need to be ironed out

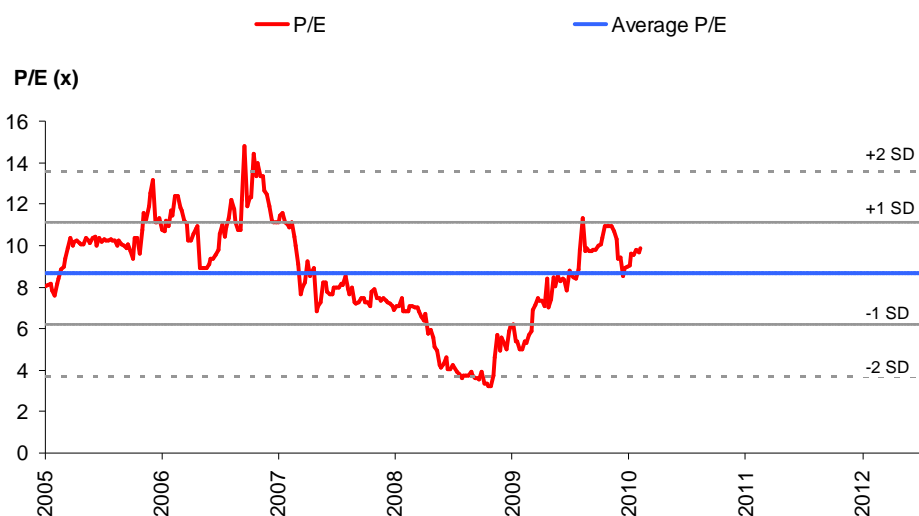
Notion targeting 5% rejection rate

Maintain BUY, target price revised to RM3.74

We raise EPS forecast by 3-5% for FY10-12 to account for the aborted private placement which we had previously factored in while imputing higher interest costs as the company seeks debt financing as replacement for funding needs. In addition, our EPS numbers have been adjusted to reflect EPS dilution from the in-the-money warrants.

Hence, we revise our TP from RM3.63 to RM3.74 based on an unchanged PE multiple of 9x on mid FY10/11 adjusted EPS of 41.6 sen. We believe a PE multiple of 9x is fair as Notion has historically traded at an average forward PE multiple of 8.6x. Valuation is compelling given its strong FY09-12 adjusted EPS CAGR of 37.3% and low PEG ratio of 0.26 based on FY10 EPS growth of 31.6% over FY09. A PEG ratio less than one for a growth stock implies that it is undervalued.

Figure 1 : Notion forward P/E trend



Source: Company

Notion VTec Berhad
Financial Summary
Price date: 23 July 2010
Balance Sheet

FYE 30 Sep (RM m)	2008A	2009A	2010F	2011F	2012F
Fixed Assets	151.9	161.8	260.7	309.4	365.4
Inventories	22.3	20.1	30.1	45.3	59.0
Receivables	44.4	50.9	73.7	108.5	139.8
Other Assets	1.4	2.2	3.2	4.2	5.1
Cash	17.6	20.5	108.7	111.5	98.5
Total Assets	237.6	255.4	476.4	579.0	668.0
Payables	35.9	17.2	22.1	29.6	36.3
ST Borrowings	18.4	16.9	16.9	16.9	16.9
LT Borrowings	31.3	40.1	168.8	202.0	201.9
Other Liabilities	14.1	16.6	16.6	16.6	16.6
Liabilities	99.7	90.7	224.3	265.0	271.7
Share Capital	70.4	70.4	85.0	85.0	85.0
Reserves	-	0.2	31.1	31.1	31.1
Shareholders' Equity	136.8	163.6	250.9	312.7	394.9
Minority Interests	1.1	1.1	1.2	1.3	1.4
Total Equity	137.8	164.7	252.1	313.9	396.3
Total Equity and Liabilities	237.6	255.4	476.4	579.0	668.0

Cash Flow Statement

FYE 30 Sep (RM m)	2008A	2009A	2010F	2011F	2012F
Pretax Profit	40.9	43.0	63.0	93.1	124.0
Depreciation	13.3	18.2	21.0	31.3	34.0
Change in Working Capital	(15.6)	(12.6)	(27.9)	(42.6)	(38.3)
Tax Paid	(5.4)	(6.8)	(10.7)	(15.8)	(21.1)
Others	(0.3)	0.0	(1.0)	(1.0)	(1.0)
Operating Cash Flow	32.8	41.9	44.4	65.1	97.6
Capex	(21.1)	(18.6)	(120.0)	(80.0)	(90.0)
Others	0.1	0.2	-	-	-
Investing Cash Flow	(21.0)	(18.3)	(120.0)	(80.0)	(90.0)
Dividends Paid	(12.3)	(7.0)	(10.4)	(15.4)	(20.6)
Change in Debts	6.0	(0.9)	128.7	33.2	(0.1)
Equity Capital Raised	-	0.6	45.5	-	-
Others	(8.6)	(13.8)	-	-	-
Financing Cash Flow	(14.8)	(21.1)	163.8	17.8	(20.6)
Net Cash Flow	(3.0)	2.4	88.2	2.8	(13.0)
Forex	(0.0)	0.1	(0.8)	-	-
Beginning Cash	19.6	16.6	19.1	106.5	109.4
Ending Cash	16.6	19.1	106.5	109.4	96.4

Income Statement

FYE 30 Sep (RM m)	2008A	2009A	2010F	2011F	2012F
Revenue	146.1	172.7	258.8	390.2	508.4
Operating Expenses	(90.5)	(108.8)	(167.9)	(253.5)	(337.1)
EBITDA	55.6	63.9	90.9	136.6	171.3
Depreciation	(13.3)	(18.2)	(21.0)	(31.3)	(34.0)
Operating Profit	42.2	45.7	69.9	105.3	137.3
Finance costs	(2.0)	(3.7)	(7.9)	(13.2)	(14.3)
Share of Associates Profits	0.6	1.0	1.0	1.0	1.0
Pretax Profit	40.9	43.0	63.0	93.1	124.0
Taxation	(7.8)	(7.0)	(10.7)	(15.8)	(21.1)
Minority Interest	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)
Net Profit	32.9	35.9	52.2	77.2	102.8

Key Statistics & Ratios

FYE 30 Sep	2008A	2009A	2010F	2011F	2012F
Growth					
Revenue	39.8%	18.2%	49.9%	50.7%	30.3%
EBITDA	34.6%	15.1%	42.2%	50.3%	25.4%
Pretax Profit	32.3%	5.1%	46.6%	47.9%	33.1%
Net Profit	23.7%	9.0%	45.5%	47.9%	33.1%
EPS	23.7%	9.0%	32.4%	47.9%	33.1%
Profitability					
EBITDA Margin	38.0%	37.0%	35.1%	35.0%	33.7%
Operating Profit Margin	28.9%	26.5%	27.0%	27.0%	27.0%
Pretax Profit Margin	28.0%	24.9%	24.3%	23.9%	24.4%
Net Profit Margin	22.5%	20.8%	20.2%	19.8%	20.2%
Effective Tax Rate	19.1%	16.3%	17.0%	17.0%	17.0%
Return on Assets	13.9%	14.1%	11.0%	13.3%	15.4%
Return on Equity	24.1%	21.9%	20.8%	24.7%	26.0%
Leverage					
Total Debt / Total Assets	0.21	0.22	0.39	0.38	0.33
Total Debt / Total Equity	0.36	0.35	0.74	0.70	0.55
Net Debt / Equity	0.23	0.22	0.31	0.34	0.30
Valuations					
FYE 30 Sep	2008A	2009A	2010F	2011F	2012F
EPS (sen)	23.4	25.5	33.8	50.0	66.5
Adj EPS (sen)	23.4	25.5	33.6	49.7	66.1
P/E (x)	11.7	10.7	8.1	5.5	4.1
EV/EBITDA (x)	7.5	6.6	5.5	3.9	3.2
Net DPS (sen)	5.0	5.0	6.8	10.0	13.3
Net Dividend Yield	1.8%	1.8%	2.5%	3.6%	4.9%
BV / Share (RM)	0.88	1.06	1.62	2.02	2.56
P / BV (x)	3.1	2.6	1.7	1.4	1.1

Key to stock recommendations:

Buy = Share price is expected to appreciate by >10% over the next 12 months

Hold = Share price is expected to move by less than +/-10% over the next 12 months

Sell = Share price is expected to decline by >10% over the next 12 months

Key to sector recommendations:

Overweight = Industry expected to outperform the market over the next 12 months

Neutral = Industry expected to perform in-line with the market over the next 12 months

Underweight = Industry expected to underperform the market over the next 12 months

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