

INITIATION REPORT

26 April 2011

Unimech Group Bhd

Price : RM0.87

Market Capitalisation : RM119 mln

Board : Main Market

Sector : Trading/Services

Recommendation : BUY

Bursa / Bloomberg Code: 2084 / UGB MK
Stock is Shariah-compliant.

Key Stock Statistics*

FYE Dec	FY09	FY10	FY11E
EPS (sen)	9.83	11.83	13.21
PER (x)	8.8	7.4	6.6
Dividend/Share (sen)	3.70	4.00	4.50
NTA/Share (sen)	95.9	101.0	122.5
Book Value/Share (sen)	102.42	107.44	128.94
Issued Capital (m shares)	136.56	136.56	136.56
52-week Hi-Low (RM)	0.72 - 1.01		

Major Shareholders (%):

Dato' Lim Cheah Chooi	29.41
Lim Kim Guan	7.32

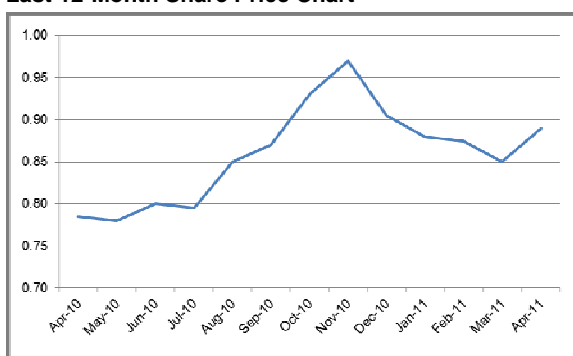
* incl of treasury shares

Per Share Data*

FYE Dec	FY09	FY10E	FY11E
Book Value (RM)	102.42	107.44	128.94
Cash Flow (sen)	17.57	21.77	25.81
Earnings (sen)	9.83	11.83	13.21
Gross Dividend (sen)	3.70	4.00	4.50
Payout Ratio	0.38	0.34	0.34
PER (x)	8.8	7.4	6.6
P/Cash Flow (x)	5.0	4.0	3.4
P/Book Value (x)	0.8	0.8	0.7
Dividend Yield	4.3%	4.6%	5.2%
ROE	9.6%	11.0%	10.2%

* incl of treasury shares

Last 12-Month Share Price Chart



* Source: Bloomberg

Investment Highlights / Summary

- **The Unimech Group deals in specialist products for applications in fluid flow engineering.** The brand name of its valves and other related products such as ARITA, Q-flex, UNIJIN, BELLS, ALLEN and, ICONTRONIC have achieved global recognition - the fruits of years of patience.
- **Established presence.** In Malaysia, Indonesia, Singapore, Thailand, Australia and China.
- **Expand the product range** and markets associated with valves, by acquiring promising small companies and applying its in-house expertise for their subsequent growth. This strategy is successful with pumps promising to be a new major contributor.
- **Capture market share** in the oil & gas, marine & shipbuilding, water works and waste water treatment sectors.
- **Strong balance sheet** with net gearing of only 0.2X.
- **Earnings in FY2011 are expected to maintain the strong momentum** achieved in FY2010, with valves maintaining its solid position as the top earner. It has instituted a 30% dividend payout ratio policy.
- **Risks** include rising costs of production and the ever intense competition – both of which conspire to bring down profit margin.
- **Recommend BUY with a target price of RM1.18**, in line with current market consensus of assigning a forward P/E of 8-10X to fundamentally sound but small cap and illiquid companies.

Background

Corporate Profile

Unimech was established in 1977. It was listed on the Second Board of Bursa in June 2000 and admitted to the Main Board (now known as Main Market) in June 2007.

The driving force behind Unimech is the 62-year-old founder Dato' Lim Cheah Chooi. He is also the Group Executive Chairman and Managing Director.

Other key members of management are his 57-year-old brother Mr.Lim Kim Guan (Deputy Managing Director) and 35-year-old son Mr.Lim Jun Lin (Executive Director). Kim Guan looks after marketing strategies, product development and China operations, while Jun Lin oversees the business development of overseas subsidiaries, development of new business segments, product quality and manufacturing operations of the Group.

Completing the management team are long serving old hands. Mr.Ngoi Foo Sing (62-year-old) is in charge of the group's business in Central Region of West Malaysia, and also participates in the overall operation and strategic business planning of the Group. Mr.Han Mun Kuan (58-year-old) is responsible for the overall business operation of the Group and the southern region of Peninsular Malaysia. While Mr.Sim Yee Fuan (44-year-old) is in charge of the corporate, finance and accounting functions of the Group.

Currently, the management team who have been in the business for over 2 decades owns a combined 49.4% of the Group with the largest shareholder being Dato' Lim Cheah Chooi (32.7%).

Corporate Structure



100% UNIMECH ENGINEERING (M) SDN BHD	100% UNIMECH WORLDWIDE (SHANGHAI) SDN BHD
100% Unimech Flow System Sdn Bhd	100% Unimech (Shanghai) Co Ltd
100% Unimech Valve Technology Sdn bhd	95% Arita Engineering (Chengdu) Co Ltd
100% Unimech International Sdn Bhd	70% Senior Industries Resources Co Ltd
100% Unimech Marine & Sanitary Equipment Sdn Bhd	
90% Unimech Instruments & Control Sdn Bhd	100% Q-FLEX INDUSTRIES (M) SDN BHD
85% UME Service & Trading Sdn Bhd	80% Unimech Polymer Engineering Sdn bhd
81% Unimech Engineering (Vietnam) Sdn Bhd	
75% Inventive Potentials Sdn Bhd	100% MULTIPLEX CONTROL & ENGINEERING SERVICES PTE LTD
61% Unimech Engineering (Aust) Pty Ltd	38% Multiplex Inst. & Ctrl. Equipment Serv. Phils., Inc
60% Luxurious Construction Sdn Bhd	30% M.E.T. Resources Pte Ltd
29% TM Unimech Co Ltd	
29% Unimech Engineering Group (Thailand) Co Ltd	100% ARITA VALVE MFG (M) SDN BHD
	100% ARITA FLANGES INDUSTRIES SDN BHD
100% UNIMECH ENGINEERING (JB) SDN BHD	100% ARITA VALVE (TIANJIN) CO LTD
100% Unimech Engineering (Kuantan) Sdn Bhd	
50% Hebei Arita Valve Industries Co Ltd	100% GRIFERIA SANITARIO (M) SDN BHD
20% TM Unimech Co Ltd	
20% Unimech Engineering Group (Thailand) Co Ltd	100% UNIMECH R & D CENTRE SDN BHD
	100% SUZHOU SKYLINE MACHINERY TECHNOLOGY CO LTD
100% ARITA ENGINEERING SDN BHD	100% M.E.T. MOTION HOLDING SDN BHD
85% PT Arita Prima Indonesia	100% M.E.T. Motion Engineering & Trading Sdn Bhd
100% PT Arita Prima Gemilang	100% M.E.T. Motion (Alor Setar) Sdn Bhd
70% PT Ragam Teknik	70% M.E.T. Motion (Ipoh) Sdn Bhd
70% PT Arita Prima Teknindo	70% M.E.T. Resources Pte Ltd
70% PT Arita Prima Kalbar	
40% Arita System Sdn Bhd	51% UNIJIN INSTRUMENTS INDUSTRIES SDN BHD
	51% ICONTRONIC TECHNOLOGY SDN BHD
100% UNIMECH ENGINEERING (KL) SDN BHD	40% PREMIUM HEIGHTS SDN BHD
51% TCE Casting Sdn Bhd	
51% Unimech Engineering (Korea) Ltd	
100% UNIMECH CAPITAL SDN BHD	
100% Bells Marketing Sdn Bhd	
100% Bells Saga Sdn Bhd	
80% Unimech FPC Sdn Bhd	
60% Tri Axis Technology (M) Sdn Bhd	
60% Arita System Sdn Bhd	
51% Icontronic Sdn bhd	
49% Unimech Bersatu Malaysia Sdn Bhd	
40% TTS Valve Technologies Sdn bhd	
24% MKT Marketing Sdn Bhd	

* Source: The Group

Business

Unimech started as an engineering sub-contractor for commissioning, maintenance and repairing of industrial boilers and piping systems. Since then, the Group's business has evolved and become more specialized. The core business is now in the manufacture and sales of products for fluid flow engineering and its major customers are in the heating, ventilation and air-conditioning sectors.

Unimech's product range is reported under the following categories;

- (i) Valves, instrumentation & fitting – Systems design, fabrication, manufacturing and distribution of all kinds of valves, instrumentation and fittings
- (ii) Heat and steam engineering – Fabrication, installation and maintenance of boilers, combustion equipment and piping systems
- (iii) Electronic – Manufacture of electronic products, components and other related products
- (iv) Pumps – System design, fabrication, assembly, distribution of all kinds of pumps and provision of related services
- (v) Others – Include manufacture of metal stamped parts and tools, construction and trading of sanitary and kitchen products

Unimech owns 6 established brand names under its manufacturing division namely Arita, Q-Flex, Unijin, Bells, Allen and Icontronic. It is also the sole distributor for Riello Burners and Rotatool.

As a one-stop provider of systems and equipment for the heat, ventilation and air-conditioning sector, Unimech has established a distribution network that serving a customer base of more than 5,000 in the region. The Group does not rely on single large customer's contribution, and we understand that most of its sales are recurring.

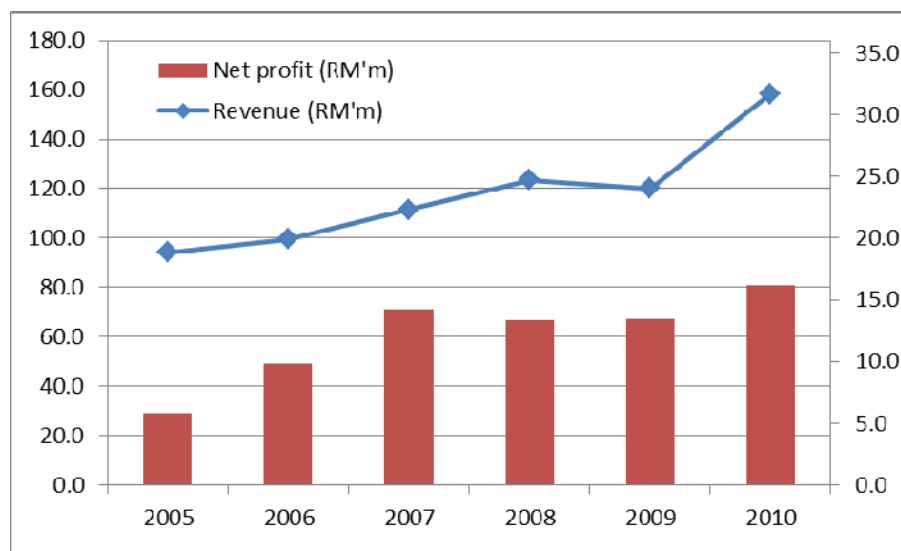
Strategy

Since the early 2000s, the Group has been implementing growth strategy by initially focusing on:

- ✓ **Achieving global brand status for its valve and related products.** With manufacturing facilities in Malaysia and China, it has secured market presence in countries that are rapidly industrializing namely Singapore, Philippines, Thailand, Indonesia and Vietnam. Currently, 30% of total revenue is attributable to overseas markets for example Singapore and Indonesia.
- ✓ **Constantly identifying synergistic acquisition targets amongst small/ emerging companies** that engage in business related or complementary to its core business

Unimech's past acquisitions were mainly funded by internal reserves. Those acquired companies have benefited from Unimech's in-house expertise and incorporation into its business culture.

Going forward, it is targeting to leverage on the global recognition of its own brands to capture market share in the oil & gas, marine & shipbuilding, water works and waste water treatment sectors as well as expanding further in Indonesia, Thailand and Vietnam markets.

Financial Highlights (FYE Dec)**Group Revenue & Net Profit (FYs 2005-2010*)**

* Based on the unaudited results of Q42010

RM'm	2005	2006	2007	2008	2009	2010
Revenue	94.1	99.7	111.5	123.6	120.1	158.4
Pre-tax profit	9.0	14.3	18.4	19.7	18.9	23.9
Taxation	-3.0	-4.0	-4.4	-5.3	-4.4	-5.9
Minorities	-0.2	-0.5	0.3	-1.1	-1.1	-1.8
Net attributable profit	5.8	9.8	14.3	13.3	13.4	16.2

Key Indicators:

Gross margin	29.8%	33.4%	34.4%	37.9%	37.8%	32.3%
Net margin	6.2%	9.8%	12.8%	10.8%	11.2%	10.2%
Revenue to fixed asset ratio	4.3	4.6	5.2	3.7	3.6	3.4
Revenue to overhead ratio	4.7	4.9	4.6	4.5	4.2	5.3
Effective tax rate	33.3%	27.6%	24.2%	27.0%	23.0%	24.8%

After registering 11% and 12% annual sales growth in FY2008 and FY2007 respectively, total sales in FY2009 fell back by 3% as demand faltered due to the 2008/2009 financial crisis. Nevertheless, the management has been able to maintain double-digit net margin for the past 5 years.

Segmental Breakdown of Revenue & Results

RM'm	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Revenue by business segments						
Valves, instruments & fittings	85.2	86.6	94.8	102.8	87.9	116.9
Heat & steam engineering	3.2	6.9	3.9	4.5	4.9	5.1
Electronic	-	-	8.1	9.2	7.0	8.3
Pumps	-	-	-	-	15.2	20.8
Others	5.7	6.2	4.8	7.0	5.1	7.2
	94.1	99.7	111.5	123.6	120.1	158.4

Segment Results

Valves, instruments & fittings	11.6	14.8	21.4	20.3	19.0	21.8
Heat & steam engineering	-0.9	0.7	-0.3	0.4	0.5	0.5
Electronic	-	-	-0.1	0.6	-0.4	0.3
Pumps	-	-	-	-	1.4	2.6
Others	-1.0	-0.7	-0.9	-1.0	-0.5	0.1
	9.6	14.7	18.9	20.4	20.0	25.2

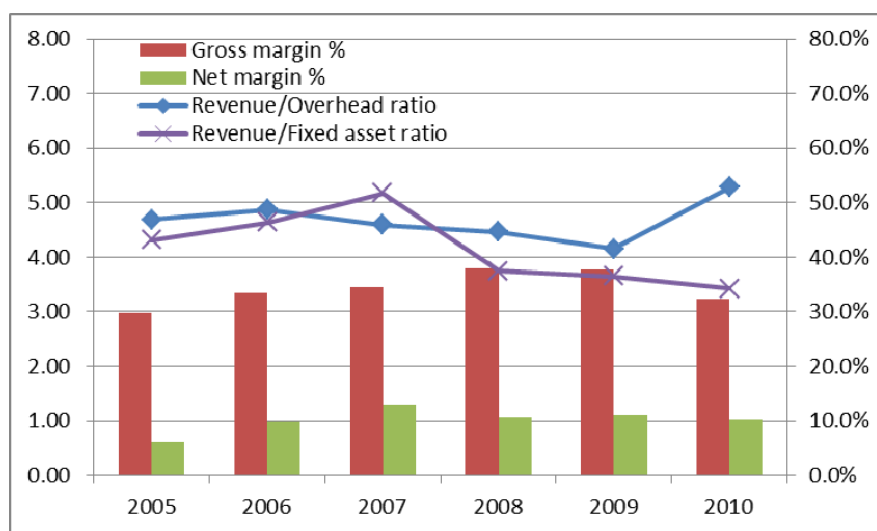
Unimech's 6-year track record reflects the management's focus on establishing market acceptance of its valve products, since both revenue and profit are almost exclusively dominated by the division.

The timely first full year inclusion of the results of the pump subsidiary (that was acquired in 2008) was able to mitigate the impact of the decline in valve sales so that the Group sales and profit in FY2009 were maintained at around the FY2008 levels.

With the recovery of the economy in 2010, sales resumed its upward trend. Valves posted record high annual sales by jumping 33% y-o-y to RM117m. Pumps also reached a new high of RM21m and contributed to 10% of the total profit, compared to 7% in FY2009.

Economies of scale

Thus far, growth in net profit still lags that of revenue, indicating that Unimech's manufacturing operations have yet to achieve economies of scale. However, in FY2010, revenue to overhead ratio has reversed its downward trend for the first time to 5.3X from a low of 4.2X in FY2009. On the other hand, revenue to fixed asset ratio continued to decline, implying that the capacity utilization at newly acquired subsidiaries is still below optimal.



Cash Flow & Balance Sheet

Unimech has achieved a solid and conservative balance sheet throughout the years, thanks to its ability to maintain good margins. It has accumulated sufficient reserves not only to acquire new businesses, but also to consistently pay dividends. Dividends payments were ranged from 30%-36% average and 34% over the past 5 years. Although the Group does not have a fixed dividend policy, we expect the average payment to continue in the years to come.

Balance Sheet Highlights

As at 31 st Dec	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
RM'm						
Total assets	137.2	141.5	158.3	182.4	199.8	241.7
Fixed assets	21.8	21.5	21.6	33.0	33.0	46.3
Intangible assets	1.3	1.3	3.8	4.2	8.8	8.8
Cash and bank balances	11.5	14.2	20.2	18.7	17.8	21.1
Shareholders' equity*	101.8	105.3	116.6	126.2	138.2	149.5
Minorities	5.1	5.5	6.5	7.7	9.8	11.0
Borrowings	15.4	12.9	15.4	30.0	29.3	48.5
Net gearing	0.0	0.0	-0.0	0.1	0.1	0.2
ROE	5.7%	9.3%	12.2%	10.5%	9.7%	10.8%
Dividend payout ratio (net)	33.4%	23.0%	25.6%	25.6%	25.6%	30.0%^

* Net of treasury shares

^ There was no dividend declared in respect of FY2010 in the latest 4th quarterly results. The above is our assumption based on the announcement by Unimech on 24th May 2010 – the Group set a dividend policy to distribute 30% of net profits to shareholders, with effect from the FY2010.

Unimech has maintained remarkably low net gearings (net cash in 2007 to only 0.2X by 2010) over the past 6 years. It gives the Group flexibility to adopt a more aggressive growth strategy, if opportunity arises.

Earnings Outlook

We expect the gain in market share for valves secured in FY2010 to be solidly defended in FY2011. The current success is the result of years of patience and a highly focused marketing efforts implemented since 2003.

Be that as it may, valves and fitting are likely to remain as Unimech's main profit contributor for FY2011. We are expecting a net profit of RM18m for FY2011 based on the forecast revenue of RM182m and margin of 10%.

Further out, Unimech is steadily on the way towards achieving economies of scale for its manufacturing operations. It may even be sooner than we are currently expecting if (i) demand in Singapore and Indonesia and Thailand accelerate further, and (ii) penetrations into new market (i.e Pumps) achieve early success.

When this happens, profit growth will outperform revenue growth.

P&L Summary

	FY2009	FY2010	FY2011E
RM'm			
Revenue	120.1	158.4	182.1
EBITDA	24.0	29.7	35.2
Depreciation	-3.6	-3.7	-6.3
Interest expenses	-1.3	-2.1	-3.3
Share of associate co	0.2	0.5	0.4
Pre-tax profit	18.9	23.9	25.5
Effective tax rate	23%	25%	25%
Net profit	13.4	16.2	17.9
EBITDA margin	20%	19%	19%
Net margin	11%	10%	10%

Investment Risks

Rising costs of production due to rising fuel prices and raw materials, and intense competition would put severe pressure on profit margins.

Valuation

We have listed in the table below several listed valve manufacturers across the globe. We have also included KNM, which incorporate valves in the equipment that they manufacture, to give a sense of the range of valuation for engineering companies.

Company Name	Exch	Curr	Price	P/E	P/BV	Market Cap (m)
Unimech	KLCI	MYR	0.85	6.5	0.85	117
Velan Inc.	TSE	CAD	15.25	15.3	1.03	339
China Valves Tech., Inc.	NASDAQ	USD	6.72	4.3	1.85	233
SUFA Tech. Industry Co.	SHE	CNY	39.08	156.3	13.30	7,880
Zhejiang IDC Fluid Con.	SHE	CNY	23.00	38.3	10.79	3,680
Zhejiang Sanhua Co., Ltd.	SHE	CNY	34.40	22.6	7.38	9,080
KNM Group Bhd	KLCI	MYR	2.75	12.0	1.54	2,953

Source: Bloomberg, Group data

The valuations are quite dispersed. Unimech is considerably the cheapest after China Valves based on P/E.

Recommendation

We recommend a BUY on Unimech with the target price of RM1.18 based on (i) forward P/E of 9X, and (ii) forecast EPS of 13.14 sen for FY2011, representing an upside potential of 36%.

The target price is based on market consensus of assigning forward P/E of 8-10X to fundamentally sound small-cap manufacturing companies.

We like Unimech for its sound management who has over the years exhibited true grit and tenacity in this highly competitive business. With a broader product range and new markets, we believe that Unimech's earnings are on a sustainable and steady upward trend.

Further, with a 30% dividend payout ratio policy on a rising EPS trend, investors can look forward to higher yield.

RATING GUIDE

BUY	Price appreciation expected to exceed 10% within the next 12 months
SELL	Price depreciation expected to exceed 10% within the next 12 months
HOLD	Price movement expected to be between -10% and +10% over the next 12 months from current level

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