COVER STORY

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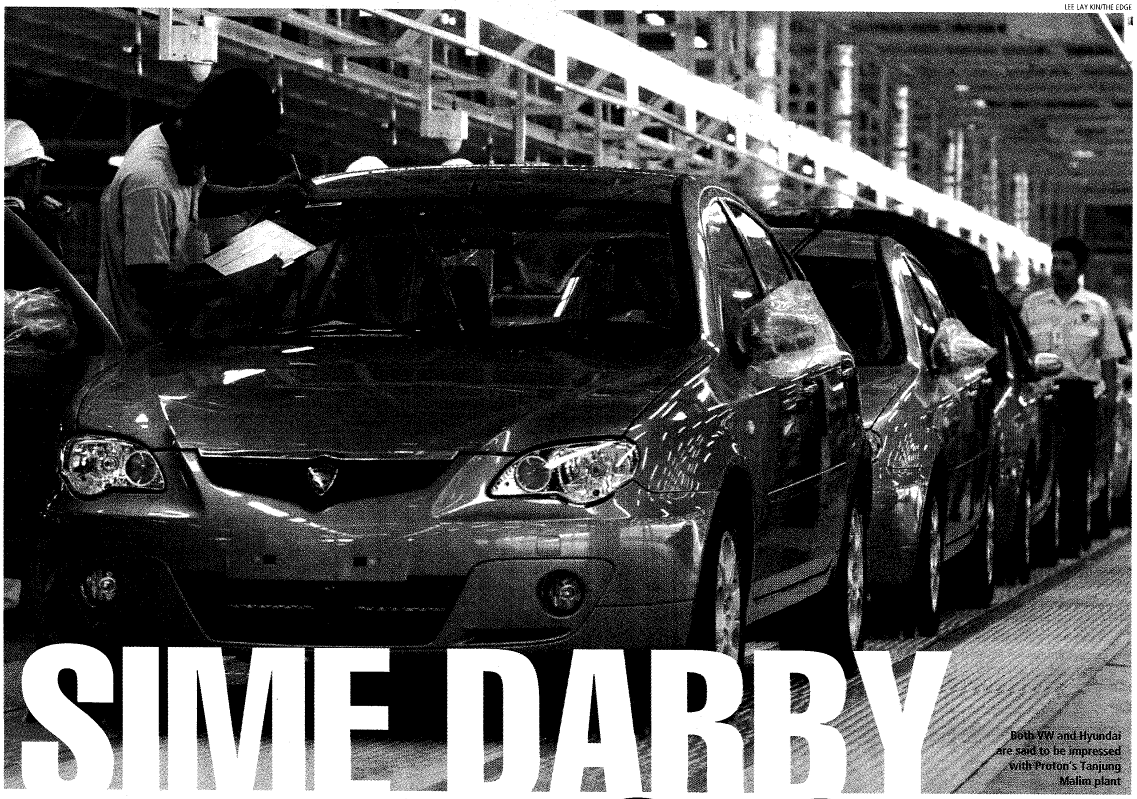

Both VW and Hyundai are said to be impressed with Proton's Tanjung Malim plant

SIME DARBY eyes PROTON

Sime has come up with what it believes is a win-win proposal to take over Proton. What does it have in mind and how will Volkswagen and Hyundai fit into the scheme of things?

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Chairman Datuk Azlan Hashim has had a busy time of things at Proton Holdings Bhd since retiring CEO Tengku Tan Sri Mahaleel Tengku Ariff went on leave in late July. But even while Azlan delves through years of material at Proton, the government has been considering a proposal on how to take the national car company forward.

Sources say Sime Darby Bhd, very keen to have Proton in order to take its already substantive auto business up a notch, has come up with a solution it believes is win-win for all parties.

The proposal, sources say, is for Sime to buy a 32% stake in Proton Holdings from Khazanah Nasional, which owns 42.7% in the national car company.

Sime can pay for the stake either with cash or through an issue of new shares. If it is via shares, Khazanah will end up with a substantial stake in Sime, whose controlling shareholder is Permodalan Nasional Bhd.

Sime did not respond to questions from *The Edge* and Khazanah declined to comment.

Sources also tell *The Edge* that the government has yet to make a decision on the Sime proposal. They also do not expect any decision to be made until after Azlan, who is running Proton in the absence of a CEO, has completed his assessment of the company — from its operations to the financials. This could take anywhere from several weeks to a few months.

It is believed that under the Sime proposal, either simultaneously of it coming into Proton or at a later stage, German automaker Volkswagen AG (VW) should forge a deal with Proton to cement planned collaborations and tie-ups.

It is as yet unclear what role Hyundai Motor Co of South Korea will have in the end game, though sources indicate that the Koreans could be part of the scene too. Sime is the local assembler and distributor of Hyundai vehicles in Malaysia.

"Hyundai has been on the lookout to secure an Asean base and Malaysia may well fit the bill as long as the terms of the National Automotive Policy (NAP) are attractive enough. Hyundai could still have those assembly facilities within a Proton framework, even if there is a bigger tie-up with VW on the cards," says a source.

However, industry players say that Hyundai is also looking at Thailand as a possible hub for its Asean aspirations.

But why would Sime take over Proton?

A source says Sime was invited to take a stake in Proton "a long time ago" when the "situation was somewhat different".

This may be an oblique reference to the time when Mahaleel was chief executive and it was felt that the Khazanah-led board had no control over their CEO.

However, with the appointment of Azlan as Proton's chairman in February this year, it was clear that Khazanah was trying to exert more control over the Proton CEO. As such, there were rumblings of discontent long before Mahaleel's retirement was announced on July 25.

Even with Mahaleel's departure, there is a case for Sime to take the strategic controlling stake in Proton because it would be easier for a commercial entity to fix the problems at Proton, especially if it is not so closely linked to government and policymakers.

"At the end of the day, Proton cannot any longer remain a subsidised entity, supported by Malaysian car buyers. However, as long as it is so closely tied to the government's apron strings, it is difficult to make that progression from a protected entity to a commercially viable one," says a source.

But looking at it from Sime's perspective, Proton would fit in tidily with its existing motor operations, though admittedly, Proton would be a bigger bet than any Sime has made in the sector thus far. Sime has for a long time been assembling and distributing marques like BMW, Ford and Land Rover with operations in the region. In the last year, it landed franchises like Hyundai and Alfa Romeo as well.

"Sure, Sime has been more an assembler and a distributor of established marques. But it is definitely no stranger to the business," notes a fund manager. "The question is, will Sime be able to take Proton and do what is necessary?"

Among what would be considered "necessary" is of course making the tough decisions to cut off the gangrenous parts of the company, the ones where there may be more sentimental value than commercial.

This is going to be a tough call for the conglomerate, though having said that, it must be noted that the new management under chief executive Datuk Ahmad Zubir Murshid has over the last year made all the right moves to streamline group operations into six core businesses. Thus, non-core assets have been or are going to be disposed of and acquisitions thus far have focused on the core businesses.

Be that as it may, Proton remains a risky investment proposition especially considering its recently announced 1Q2006 results.

"There is obviously some concern about Proton's financial well-being. Sure, it has over RM2 billion in cash, but what about its liabilities and commitments? And where is growth going to come from if both its domestic market share and sales volume are dropping?" comments the fund manager.

For 1Q2006, Proton posted a net loss of RM12.4 million thanks in large part to provisions of RM136.5 million. Revenue increased 6.9% to RM2.05 billion during the period, though sales fell by 6.5% quarter-on-quarter to 36,742 units.

Of greater concern was perhaps the admission by Proton's senior management that there could be further provisions going ahead. Worse, this news comes on the back of the fact that there is as yet no indication of viable new models that can replace ageing existing ones.

"This is where Sime's role becomes crucial. As a purely commercially driven entity, Sime will be able to make the right moves to ensure that the decline at Proton is stemmed first, after which it can rebuild from a stronger base," says one analyst. "But it's not going to be easy and it is going to take a lot of discipline," he adds.

But could Khazanah do the same? Probably, but the weight of social considerations could sit heavily on the government's investment arm, where Sime would not have similar constraints.

Proton's worth

Sources say that Proton shares will be valued at between RM8.50 and RM9.

"At these levels, it is estimated that Sime could end up paying between RM1.5 billion and RM2 billion for the Proton stake," says one source.

At RM8.50 a share, a 32% stake in Proton would cost RMRM1.5 billion. At RM9, the same stake would cost RM1.58 billion. The entire 42.7% stake at RM8.50 per share would cost RM2 billion while at RM9 per share, it would come to RM2.1 billion.

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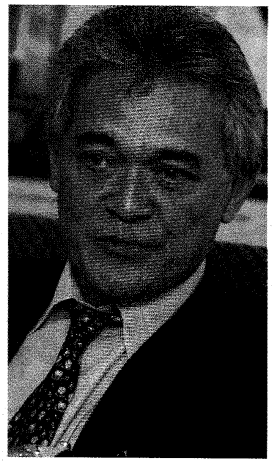

With Mahaleel's departure, there is still a case for Sime to take the strategic controlling stake in Proton

It was clear that Khazanah was trying to exert more control over the company's CEO when Azlan was made Proton chairman

Furthermore, if Sime should take Khazanah's entire 42.7% block in Proton, it would be required to make the GO for the rest of Proton. A GO at RM8.50 per share would come to RM4.67 billion and at RM9 per share it would cost RM4.95 billion.

Whatever the permutations, and even if it is a cash deal, what does seem clear is that Sime can afford to take on Proton.

"With operating cash flows of RM500 million to RM700 million a year, and over RM2 billion in cash, Sime can easily gear up to buy whatever it wants," says an analyst.

Should Sime take the tack of issuing new shares for its Proton block, Khazanah could become a significant shareholder in the country's largest conglomerate.

If Proton is valued at RM8.50 and Sime at RM6 a share, it is estimated the conglomerate will issue some 249 million new shares for a 32% block in Proton, which will work out to 9.4% of its enlarged paid-up capital. If Proton is valued at RM9, Sime will have to issue 263 million new shares, which will be about 10% of Sime's enlarged capital.

It is equally possible that Sime may decide on a combination of shares and cash for the deal, which should suit Khazanah fine as it gets to recoup some of its investment in Proton and enlarge its war chest.

A Proton official pointed out, however, that valuing Proton on its share price may not be accurate or equitable.

"The sum of its parts is worth a lot more than what its share price implies," says the official. "And then there is the potential of the business it is involved in. This could be worth a lot more."

On the flip side would be the inherent risk of the auto business and the fact that Proton is not an attractive investment proposition at this time.

"Whoever takes Proton has a lot of hard work ahead, even with the collaboration from a foreign partner," says the source.

The foreign partner(s)?

After the change of shareholder, it is understood that either or both VW and Hyundai will be offered collaborative tie-ups with Proton.

It is understood that the VW proposal should not vary in essence from what has already been reported in *The Edge* earlier.

"VW will be involved in the development of new models with Proton," says a source.

In a nutshell, VW should acquire an equity stake in a new company (Newco), which will be jointly owned by Proton and the German automaker. It is believed that VW may accept a 49% equity stake in Newco, which will control Proton's manufacturing, marketing and engineering businesses.

Newco will then develop and manufacture new Proton cars first for the regional markets and then for other markets beyond.

An analyst familiar with Proton estimates that the three divisions VW is interested in could be valued anywhere between RM4 billion and RM5 billion.

"But this would include most of Proton's cash pile of RM2.6 billion as well. We estimate that some RM2.1 billion of Proton's cash is in the manufacturing division. Taking out the cash, the manufacturing, engineering and marketing divisions could be worth some RM3 billion or thereabouts," the analyst says.

It is not clear what value will be placed on the three Proton divisions or VW's technical expertise, which may include not just engines and platforms but also intellectual property.

One point of contention that may arise in the final stages of negotiations is Proton's RM1.8 billion manufacturing plant at Tanjung Malim, which is considered the jewel of the group. Both VW and Hyundai are believed to be impressed with the facility and have expressed interest in the plant at some point.

However, Proton has another plant in Shah Alam, which analysts say needs to be refurbished with new machinery, but which is sitting on land valued at over RM1 billion.

"VW wants to develop new models and thus it wants the Tanjung Malim plant," says a source. "But Hyundai also wants a plant for its regional assembly operations. Whichever party gets access to Tanjung Malim could start operations almost straight off the bat. If they get Shah Alam, they would have to invest time and money getting it organised first," notes the source.

What is clear thus far is that no final decision has been made on Proton's future partner. Meanwhile sources say that VW is frustrated at the delay in getting the deal together and Hyundai is looking with greater interest at Thailand.

That said, everyone knows the government has to come out with a solution for Proton, whether it's the Sime proposal or some other plan.

When can we expect a decision?

"The government will be announcing the NAP soon. That should tell you around when [the future of] Proton will be [decided]," a source says. // E