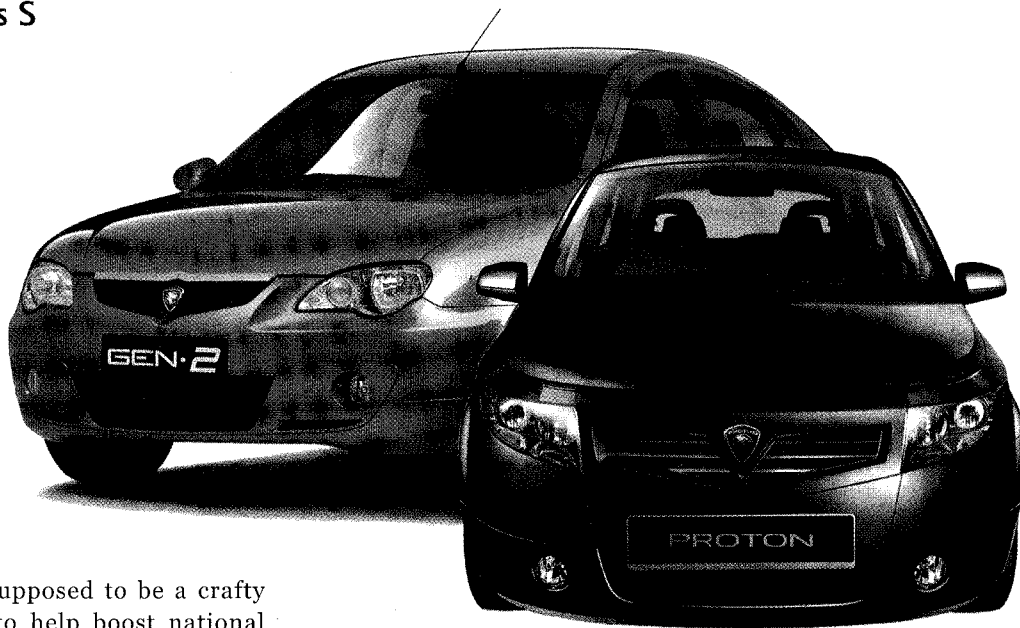


Seeking the Right Partner

National carmaker Proton has been on the lookout for ways to boost its presence in the local auto industry. However, more substance and less form is needed if it is to succeed.

■ By James S



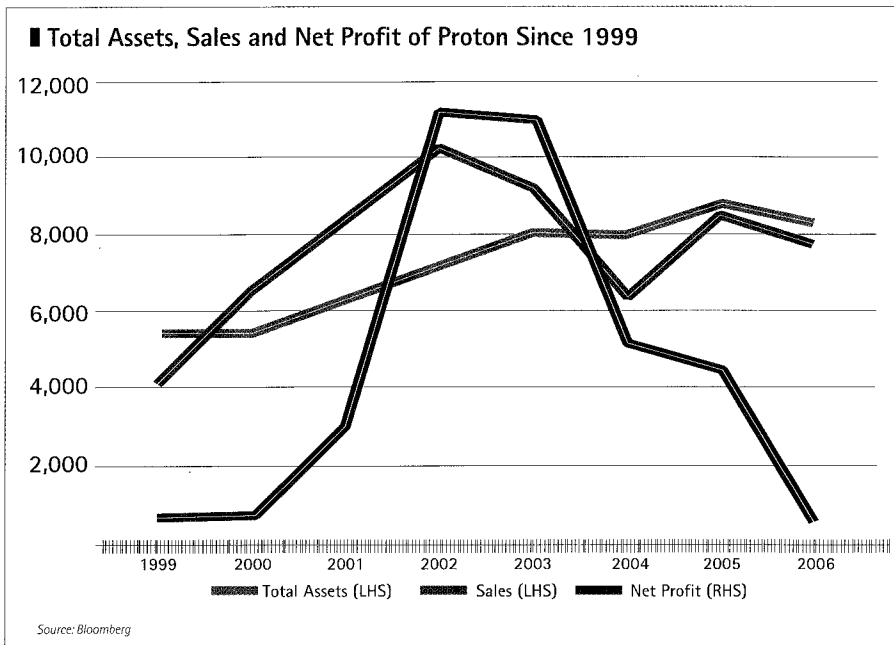
IT WAS supposed to be a crafty method to help boost national carmaker Proton Holdings Bhd (Proton) and shore up the local auto industry's declining sales, but an ill-thought one, at best. And not surprisingly, to the delight of consumers, the idea has now gone straight into the rubbish bin. According to local stockbroker CIMB Research, the much-talked-about proposal to scrap cars aged above 15 years is no longer under consideration, as its implementation could lead to some socio-economic problems. It made the conclusion in a report to clients after the research house met up recently with Datuk Aishah Ahmad, the president of the Malaysian Automotive Association.

According to the report, although such a policy would undoubtedly boost sales of new cars, it would prove unpopular with consumers, especially retirees with no fixed monthly income. Some consumers may also end up taking unnecessary loans, especially since the proposed compensation of about RM5,000 per car would be just a fraction of the cost of a new car.

As such, to resolve the glut in the second-hand car market right now, the obvious option is for local carmakers to scale down production. The National Automotive

Policy (NAP) has ruled out the issue of new manufacturing licences until the overcapacity issue is resolved. Industry utilisation is apparently now only around 50%, pointing to the severe overcapacity in the industry.

The NAP now encourages car players involved in the mid- to high-volume segments to use only their existing excess capacity if more capacity is required. Another option is to push the export of second-hand cars to neighbouring countries to solve the glut situation. However, in this case, there is still the issue



of import duties imposed by neighbouring countries, for instance, the 5% import duty levied by Thailand.

With a slower used-car market coupled with poor resale value, the growth in auto population — especially for the new car segment — is only likely to be moderate ahead. Together with lower capacity utilisation, national automaker Proton seems to be heading for tougher times ahead. The company is considering various steps to overcome these hurdles but will they be enough to turn this lumbering local icon around?

Lots of news flow but...

Proton has certainly been in the limelight this year as it searches for potential new strategic business tie-ups. To name a few, EP Manufacturing Bhd (EPMB), in collaboration with its technology partner Bosch, has been awarded a letter of intent (LOI) by Proton to develop and supply an improved Intake Air-Fuel Module to help boost the performance of Proton's Campro engines.

In addition, Proton and Peugeot Citroen (Peugeot) signed an LOI to explore potential cooperation in the areas of product development, manufacturing, quality initiatives, vendor development, contract assembly and distribution on Sept 15. This is a similar alliance to the one with the Volkswagen Group that failed some

time back.

It is good that Proton has finally taken more initiatives and concrete steps to further improve its operations, in line with its new corporate tag line — 'Dare to Change'. However, there are many who doubt whether Proton can really see through the Peugeot tie-up, given the earlier failure of its proposed venture with the Volkswagen Group.

The market certainly does not seem to be excited, judging from the continued lacklustre performance of the company's share price, which has been hovering around RM5.00/share since the tie-up announcement. For most part of the year, the share price has been trending down from a high of around RM6.50 in May to as low as RM4.50 recently before making a recovery to the current price of RM4.84.

Tie-up with Peugeot — substance or form?

To recap, the key points of the LOI between Proton and Peugeot are as follows:

■ The study of potential collaboration will take effect from Sept 15, 2006 and expire on Jan 1, 2007.

■ It will focus on various areas of interest, including product development, manufacturing, quality initiatives, vendor development, contract assembly and distribution.

■ The study has a number of objectives. From Proton's perspective, its goals are to leverage on the technological expertise of a major global auto manufacturer in areas such as product development and quality improvement, as well as to optimise the utilisation of its plants.

■ In the case of Peugeot, in line with its strategy of creating dedicated co-operation with other car manufacturers, the tie-up is expected to increase sales of Peugeot and Citroen vehicles in Malaysia and serve as a foundation for developing business in the Asean region.

Peugeot has been quoted as saying that there are no plans for any capital ties between the two companies, in line with its strategy of working with other automotive groups on specific industrial programmes only. It is believed that the study will last a few months and the outcome, at best, will only be known by next year.

In the meantime, according to another local stockbroker HLG Research, it believes that the business tie-up will lead to a win-win situation, whereby Proton's manufacturing plants and its excess capacity will enable Peugeot to begin assembly works quickly to tap into the Asean and the bigger Asian markets, as the Peugeot and Citroen marques have an insignificant presence in Malaysia currently. Last year, only 461 Citroen cars were sold in the country.

Furthermore, it says that the NAP dictates that no new manufacturing licences will be issued to new players in order to curb the excess capacity in Malaysia. Besides, to Peugeot, Proton is also familiar with the domestic market apart from the potential research and development (R&D) expertise that could come from Lotus.

In the case of Proton, its agenda is skewed towards product development and technological expertise, says CIMB Research in its report. However, the research house expresses concern as to the extent of R&D and technology transfer that Proton can reasonably expect in the absence of equity participation by its foreign partner. In such absence, it believes that the tie-up is unlikely to create much value for Proton if its role is to be a mere assembler for Peugeot.

Note that Proton did work with another foreign car manufacturer, Citroen, to develop the 'Tiara model' back in the 1990s but the model did not do well. While the potential alliance is still sketchy, many analysts in town are already speculating on the actual possible 'tie-up' methods. According to HLG Research, there are five possible methods that the alliance, if indeed it materialises, can possibly take shape:

- Formation of a joint-venture company with Khazanah Nasional Bhd (Khazanah), the government's investment arm, holding a majority stake to 'protect' national interest,
- Cross shareholding between Peugeot and Proton, a la the Renault-Nissan shareholding structure to cement the relationship,
- An outright sale of Proton to Peugeot,
- Peugeot taking an interest in Proton's manufacturing facilities and marketing division, and
- No equity interest – merely an ad hoc co-operation whenever synergistic benefits arise.

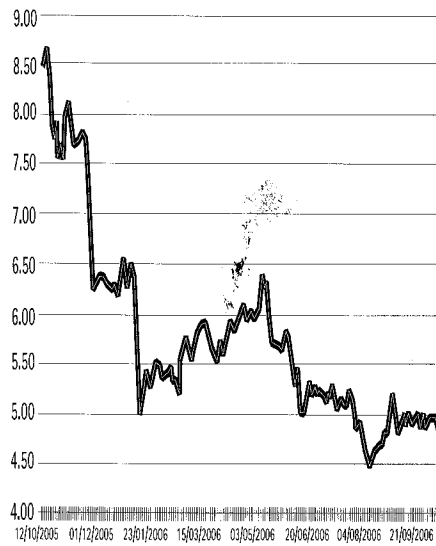
The research house further elaborates that given Peugeot's 1H2006 net cash and equivalent of roughly RM3.48 billion position, the first and third options are certainly within its financial reach. Depending on whether Peugeot will obtain majority stake and management control, valuation is expected to differ. Nonetheless, for Khazanah to relinquish its stake, the research house believes that Peugeot will have to offer 0.9x to 1.0x price to net tangible assets (P/NTA) to induce a sale. Of course, on the flip side, Peugeot will be reluctant to pay beyond 0.8x P/NTA if it doesn't obtain majority stake, given that the current share price is only roughly 0.5x P/NTA.

Apart from pricing and meaningful equity interest, another major stumbling block could be national pride if Peugeot obtains a majority stake or control over Proton. As such, the alliance, if it materialises, will likely only encompass joint-development programmes (including R&D) and other 'soft' areas like market knowledge as well as assembly works by Proton on behalf of Peugeot.

In this case, analysts say that there would be little value added to Proton's technology,

price chart

One-Year Price Movement of Proton



Source: Bloomberg

and most are not expecting any meaningful bottom-line contribution to Proton from such a mode of tie-up, given the thin assembly margins.

New takeover developments?

Apart from the ongoing possible Proton-Peugeot tie-up, a local Press report says that Tan Sri Syed Mokhtar Albukhary could be in the midst of setting up a joint-venture company with a foreign party to acquire the Proton shares that are currently held by Khazanah. Khazanah currently holds a 38.3% stake in Proton (or 210.5 million shares).

Some market participants speculate that Syed Mokhtar could be looking to merge DRB-Hicom Bhd (one of the largest motor groups in the country with an assembly plant in Pekan, Pahang) and Proton should he manage to secure the controlling stake. And, ultimately, Proton's plant in Tanjung Malim will take over all assembly work contracts for the entire group. DRB will, meanwhile, continue to focus on the automotive distribution business. Currently, DRB has the widest range of marques under its distribution umbrella.

According to another local research outfit, pricing holds the key for such market talk. Compared with its latest closing price of RM4.84, the NTA/share of Proton is

significantly higher at RM10.95 per share. However, about RM1.2 billion of its RM4.3 billion current assets comprise of unsold stocks, which could suffer depreciation, says the research outfit. As such, stripping off the unsold stocks, the adjusted NTA/share of Proton is estimated at a lower RM8.80/share only. Another question is whether the acquisition makes sense, given that both DRB's Pekan and Proton's Tanjung Malim assembly plants are actually under-utilised at the same time.

Thai market a new opportunity?

There are also reports that Proton is set to ink a deal with one reputable Thai firm to distribute Proton cars in that country. Although there has been no official announcement from Proton to deny or confirm such talk, analysts are generally not too excited, given that the immediate term contribution is likely to be negligible, if it does materialise. This is because the Thai market is already competitive with well-known brands like Toyota, Honda, BMW and Ford that are currently dominating the market there.

Therefore, penetrating the market in Thailand could be a tough task for Proton. Furthermore, Proton may need to commit a significant amount of capital for customer loyalty and brand-building activities. On top of this, setting up 'after sales service' to cater to Proton cars could be costly and time consuming, say analysts.

At the crossroads

It would seem that Proton is caught in a dilemma, where the group's competitive advantage in the local market is slowly but surely being eroded even as its initiatives to penetrate overseas markets take considerably more time and costs than expected. A foreign strategic tie-up could probably raise the question of national pride apart from pricing, as well as equity interest arrangement.

Proton certainly has much soul searching to do on exactly what it wants to be ahead. In the meantime, analysts are not exactly waiting for the outcome with the consensus view wholly underweight on the stock, with a target fair value of RM5.00/share. Nostalgic investors are certainly hoping that Proton can spring some surprises ahead to prove its detractors wrong. **mb**