

05 July 2017

KESM Industries Bhd

On a Strong Expansion Cycle!

We spoke with KESM's management recently and renewed our optimism on the company's prospects. With the recent 9M17 report card demonstrating a marked acceleration on CAPEX of RM81.2m as compared to RM30m for the entire FY16, and coupled with a faster-than-expected ramp up of prior quarters' new testing equipment, we now believe our prior estimates are overly conservative. Post increasing our CAPEX assumptions and factoring higher utilisation rate of existing machineries, we upgrade our FY17E/FY18E NP growth to 33.0%/16.4% from 26.5%/14.1% and introduce FY19 estimates. At the same time, we roll over our valuation base year FY18 to CY18 for a higher TP of RM17.60 based on 15x PER.

Impressive set of 9M17 numbers. To recap, KESM delivered a strong set of 9M17 results with revenue growing 17.5% YoY to RM248.2m and NP jumping 35.1% YoY to RM30.6m. The strong top-line results were driven by capital investments in prior quarters which allowed the Group to capitalise on the higher demand for burn-in and testing services. Meanwhile, EBIT increased by a larger quantum of 26.6% with margins expanding 1.0ppt to 14.0%. Effective tax rate also came in lower by 3.1ppt at 12.7% resulting in higher net margins by 1.6ppt to 12.3%.

9th straight quarterly revenue growth. Of note, the shift in focus towards burn-in and testing of semiconductors for the automotive industry is paying back in droves. Automotive semiconductors account for 70-80% of revenue base and provide the Group with longer product life cycles and a recurring business (3-7 year life cycles compared to the commercial segments which averaged at the lower end of the 1-7 year life cycles and with more volatile demand). The smoothened quarterly delivery has been apparent, evidenced by the 3Q17 numbers providing a ninth-straight sequential improvement to quarterly revenue.

CAPEX plans to accelerate. After a slowdown in expansion plans in FY16 due to the delayed roll-outs from its clients, KESM is poised to achieve a record year on capital investment spend for FY17. The 9M17 quarterly statements reflected RM81.2m in CAPEX which is already more than double the entire FY16 CAPEX of RM30m and exceeds our full-year expectation of RM75m. We understand from management that the current pace in CAPEX is likely to continue into the immediate quarters ahead, with focus on the addition of testing equipment (~70%) for automotive semiconductors and the balance for upgrading and maintenance of existing machineries (~30%).

Increasing estimates! We adjust our CAPEX assumptions for FY17E/FY18E to RM120m/RM80m from RM75m/RM80m, taking into account the current trajectory of expansion within the testing business. We gather that commissioning of new testing equipment takes 3-6 months with ramp-ups in production progressing in synchrony with the planned roll-outs of KESM's clients - leading us to assume a higher combined utilisation rate of 82%/84% (+2ppt). Consequently, we raise our revenue forecasts and hence FY17/FY18 net profits by +5.2%/+7.3% to RM40.8m/RM47.5m and introduce FY19E NP of RM54.6m.

Maintain OUTPERFORM with higher TP of RM17.60. Post model adjustments and rolling over our valuation base year from FY18E to CY18E, we derive a higher target price of RM17.60 from RM15.20 based on an unchanged target PE of 15x. We continue to like KESM and believe the company is uniquely positioned to benefit from two salient trends; (i) Rising car production by global automakers, and (ii) Increased chip content within vehicles. Risks to our call include: (i) lower-than-expected sales and margins, and (ii) longer-than-expected gestation periods.

OUTPERFORM ↔

Price: RM15.56
Target Price: RM17.60 ↑

Expected Capital Gain: RM2.04 +13.1%
Expected Divd. Yield: RM0.09 +0.6%
Expected Total Return: RM2.13 +13.7%

KLCI Index 1,762.08

Stock Information

Bloomberg Ticker	KESM MK Equity
Bursa Code	9334
Listing Market	Main Market
Shariah Compliant	Yes
Issued shares	43.0
Market Cap (RM m)	669.3
Par value per share (RM)	1.00
52-week range (H)	15.84
52-week range (L)	5.42
Free Float	42%
Beta	0.6
3-mth avg daily vol:	58,488

Major Shareholders

SUNRIGHT LTD	48.4%
COLLERY PETER	5.0%
WONG TEE FATT	5.0%

Summary Earnings Table

FY July (RM m)	2016A	2017E	2018E
Revenue	285.7	334.1	381.5
EBIT	36.7	46.8	53.9
PBT	36.2	46.8	54.5
Net profit	30.7	40.8	47.5
Core Net Profit	30.7	40.8	47.5
Consensus (NP)		38.8	47.0
Earnings Revision (%)		5.2%	7.3%
Core EPS (sen)	70.2	93.4	108.8
Core EPS growth (%)	80.2	33.0	16.5
DPS (sen)	7.5	9.5	11.0
BV/Share (RM)	6.6	7.4	8.4
Core PER	22.2	16.7	14.3
PBV (x)	2.4	2.1	1.9
Net. Gearing	-0.3	-0.1	-0.3
Div. Yield (%)	0.5	0.6	0.7

Share Price Performance



	1 mth	3 mths	12 mths
Absolute (%)	4.7%	24.5%	176.4%
Relative (%)	6.2%	23.5%	169.6%

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Peer Comparison

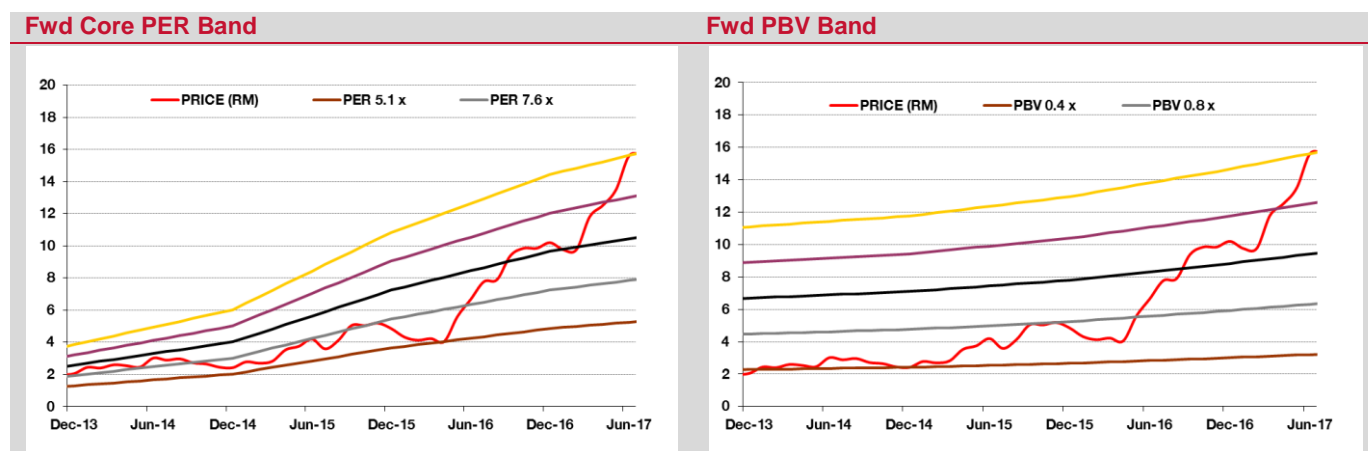
NAME	Price (4-July)	Mkt Cap (RMm)	PER (x)			Est. Div. Yld.	Fwd ROE	Net Profit (RMm)			1Y Fwd Growth (%)	2Y Fwd Growth (%)	Target Price (RM)	Rating
	(RM)		Historical	1Y Fwd	2Y Fwd			Historical	1Y Fwd	2Y Fwd				
KESM	15.56	669.1	22.2	16.7	14.3	0.6%	12.6%	30.7	40.8	47.5	33.0%	16.5%	17.60	OP
Core Coverage														
MPI	13.3	2,791.5	18.6	15.4	14.8	2.0%	16.8%	149.9	180.7	188.2	20.5%	4.2%	14.85	OP
UNISEM	3.62	2,656.4	16.6	15.5	15.3	3.4%	12.1%	160.5	171.1	174.0	6.6%	1.7%	3.55	MP
NOTION	1.19	390.1	150.0	15.4	11.1	2.5%	6.8%	2.6	25.4	35.2	876.9%	38.6%	1.66	OP
SKPRES	1.31	1,610.0	15.2	12.2	10.9	3.2%	24.4%	105.6	131.8	148.2	24.8%	12.4%	1.40	MP
PIE	2.36	906.3	23.3	13.6	12.3	3.4%	15.8%	38.9	66.4	73.6	70.7%	10.8%	2.87	OP
Peer Average			44.7	14.4	12.9	2.9%	15.2%				199.9%	13.5%		

Source: Bloomberg, Kenanga Research

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Income Statement						Financial Data & Ratios					
FY July (RM m)	2015A	2016A	2017A	2018E	2019E	FY July (RM m)	2015A	2016A	2017A	2018E	2019E
Revenue	263.1	285.7	334.1	381.5	416.4	Growth (%)					
EBITDA	82.7	92.0	109.6	124.3	138.3	Revenue	3.4	8.6	16.9	14.2	9.2
EBIT	25.1	36.7	46.8	53.9	62.0	EBITDA	13.9	11.1	19.2	13.4	11.3
Finance costs	(1.1)	(0.5)	(0.0)	0.5	0.5	EBIT	32.7	46.4	86.3	15.3	15.0
PBT	24.0	36.2	46.8	54.5	62.5	PBT	21.4	50.8	29.0	16.5	14.8
Taxation	(3.1)	(5.6)	(6.0)	(6.9)	(8.0)	C. Net Income	56.5	80.2	33.0	16.5	14.8
Minority Interest	(3.9)	0.0	0.0	0.0	0.0	Profitability (%)					
Net Profit	17.0	30.7	40.8	47.5	54.6	EBITDA Margin	31.4	32.2	32.8	32.6	33.2
Core Net Profit	17.0	30.7	40.8	47.5	54.6	EBIT Margin	9.5	12.9	14.0	14.1	14.9
						PBT Margin	9.1	12.7	14.0	14.3	15.0
						Net Profit	6.5	10.7	12.2	12.5	13.1
						Eff. Tax Rate	12.7	15.3	12.7	12.7	12.7
						ROE	6.5	10.7	12.6	13.0	13.1
						ROA	4.6	8.3	9.9	10.5	10.8
						DuPont Analysis					
						Net Margin(%)	6.5	10.7	12.2	12.5	13.1
						Asset T/over(x)	0.72	0.77	0.81	0.84	0.83
						Levg Factor (x)	1.41	1.29	1.27	1.24	1.21
						ROE (%)	6.5	10.7	12.6	13.0	13.1
						Leverage					
						Debt/Asset (x)	0.2	0.1	0.1	0.1	0.1
						Debt/Equity (x)	0.3	0.1	0.1	0.1	0.1
						N. Cash/(Debt)	24.6	77.6	42.3	63.1	99.4
						N. Debt/Eqty(x)	-0.1	-0.3	-0.1	-0.2	-0.2
						Valuations					
						EPS (sen)	39.0	70.2	93.4	108.8	124.9
						Core EPS (sen)	39.0	70.2	93.4	108.8	124.9
						NDPS (sen)	6.0	7.5	9.5	11.0	12.7
						BVPS (RM)	6.0	6.6	7.4	8.4	9.5
						PER (x)	39.9	22.2	16.7	14.3	12.5
						Core PER (x)	39.9	22.2	16.7	14.3	12.5
						Net Div. Yld(%)	0.4	0.5	0.6	0.7	0.8
						P/BV (x)	2.6	2.4	2.1	1.9	1.6

Source: Kenanga Research



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Stock Ratings are defined as follows:**Stock Recommendations**

OUTPERFORM : A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM : A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM : A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT : A particular sector's Expected Total Return is MORE than 10%
NEUTRAL : A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT : A particular sector's Expected Total Return is LESS than -5%

*****Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.**

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