

24 November 2017

KESM Industries Bhd

Commendable Start to FY18

KESM kicked-off 1Q18 with an 11th consecutive quarterly increase in revenue and a commendable earnings performance (+13.6 YoY, -15.1% QoQ) which met expectations. Although we like KESM for its unique position in the high growth automotive semiconductor business, valuations have become rich – necessitating a rating revision to UNDERPERFORM while maintaining our TP at RM18.40 based on 15x CY18.

1Q18 earnings meet expectations. At 22.8%/22.2% of house/ street's estimates, we deem the 1Q18 net profit of RM11.4m to be in-line with expectations as earnings should pick up in the quarters ahead amid a gradual ramp-up in testing capacities from FY17 blowout expansion year. No dividend was declared for the quarter as expected, although we expect a full-year dividend of 14.0 sen.

11th consecutive quarterly improvement in revenue. 1Q18 revenue grew 1.1% to RM90.7m while net profit declined 15.1% QoQ from RM13.4m to RM11.4m. We believe the stronger top-line was due to the addition of testing machinery in the previous quarters which allowed the Group to capitalise on the higher demand of burn-in and testing services. Notably, PBT grew 5.0% QoQ, aided by a lower proportion of low margin EMS services and increased operational efficiency. However, KESM's bottom-line was lower due to the absence of a tax benefit of RM0.6m which was recorded last quarter.

On a YoY comparison, revenue grew by 13.2% while net profit improved by a similar quantum of 13.6% from RM10.0m in 1Q17. The stronger top-line performance was due to higher demand for burn-in and testing capacities and capabilities mentioned above. Greater economies of scale arising from a lower proportion of employee benefits expense (+3.2%) was, however, offset by a higher depreciation charge (+31.6%) as well as a higher effective tax rate of 15.5% (+5.1ppt) which resulted in flattish NP margins of 12.5%.

CAPEX takes a breather in 1Q18 but set to resume. Although the 1Q18 financial statement indicates that CAPEX has taken a breather during the quarter (1Q18: RM13.5m; FY17: RM140.2m), we expect expansion plans to resume in the quarters ahead with focus remaining towards growing the testing business, primarily the automotive semiconductor industry. Among the initiatives taken to capitalise on the increased demand include a massive CAPEX plan, in addition to developing proprietary technologies to process high-volume automotive devices. As an indication, more than 1.7b semiconductors were processed in KESM's factories in Malaysia and China in FY17 (+19% YoY).

Maintain TP of RM18.40, revise call to UNDERPERFORM. Post earnings release, we keep our forward estimates and Target Price unchanged. We continue to like KESM given its unique position in the high growth automotive semiconductor business and believe that the company will benefit from two salient trends; (i) Rising car production by global automakers, and (ii) increased chip content within vehicles. Nevertheless, the share price has risen +107% YTD, and is currently trading at a rich valuations of 16.7x CY18 PER vs. our targeted PER of 15x. As such, we revise our call to UNDERPERFORM in accordance to our ratings definition.

Risks to earnings include: (i) lower-than-expected sales and margins, and (ii) longer-than expected gestation periods.

UNDERPERFORM ↓

Price: RM20.40
Target Price: RM18.40 ↔

Expected Capital Gain: -RM2.00 -9.8%
Expected Divd. Yield: RM0.14 +0.7%
Expected Total Return: -RM1.86 -9.1%

KLCI Index 1,721.27

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)	877.5
Par value per share (RM)	1.00
52-week range (H)	20.50
52-week range (L)	9.29
Free Float	43%
Beta	0.7
3-mth avg daily vol:	54,010

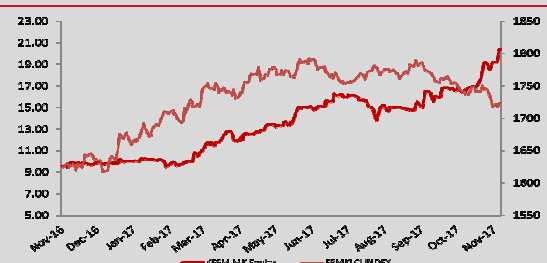
Major Shareholders

Sunright Ltd	48.4%
Wong Tee Fatt	4.8%
Tan Kong Hong Alex	4.0%

Summary Earnings Table

FY July (RM m)	2017A	2018E	2019E
Revenue	338.0	389.3	423.8
EBIT	47.8	56.7	65.2
PBT	47.8	56.6	64.5
Net profit	44.0	49.8	56.7
Core Net Profit	44.0	49.8	56.7
Consensus (NP)	-	51.3	61.7
Earnings Revision	-	-	-
Core EPS (sen)	100.7	114.0	129.8
Core EPS growth (%)	28.8	13.2	13.9
DPS (sen)	12.5	14.1	16.1
BV/Share (RM)	7.5	8.4	9.5
Core PER	20.3	17.9	15.7
PBV (x)	2.7	2.4	2.1
Net. Gearing	-0.1	-0.3	0.7
Div. Yield (%)	0.6	0.7	0.8
Core EPS (sen)	100.7	114.0	129.8
Core EPS growth (%)	28.8	13.2	13.9

Share Price Performance



	1 mth	3 mths	12 mths
Absolute (%)	22.9%	35.5%	112.1%
Relative (%)	23.7%	38.5%	106.1%

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Results Highlights

	1Q	4Q	QoQ	1Q	YoY	3M	3M	YoY
FYE July (RM'm)	FY18	FY17	Chg	FY17	Chg	FY18	FY17	Chg
Revenue	90.7	89.8	1.1%	80.1	13.2%	90.7	285.7	-68.3%
EBITDA	32.9	31.5	4.4%	25.6	28.3%	32.9	92.0	-64.2%
EBIT	13.6	13.1	4.1%	11.0	23.9%	13.6	36.7	-62.9%
PBT	13.5	12.8	5.0%	11.2	20.4%	13.5	36.2	-62.9%
Taxation	-2.1	0.6	-455.4%	-1.2	79.2%	-2.1	-5.6	-62.6%
PAT	11.4	13.4	-15.1%	10.0	13.6%	11.4	30.7	-62.9%
Net Profit	11.4	13.4	-15.1%	10.0	13.6%	11.4	30.7	-62.9%
EPS (sen)	26.4	31.2	-15.1%	23.3	13.6%	26.4	71.3	-62.9%
DPS (sen)	0.0	6.0		0.0		0.0	0.0	
EBITDA margin	36.3%	35.1%		32.0%		36.3%	32.2%	
EBIT margin	15.0%	14.6%		13.7%		15.0%	12.9%	
PBT margin	14.8%	14.3%		13.9%		14.8%	12.7%	
PATAMI margin	12.5%	14.9%		12.5%		12.5%	10.7%	
Effective tax rate	-15.5%	4.6%		-10.4%		-15.5%	-15.3%	

Source: Company, Kenanga Research

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Peer Comparison

NAME	Price (23-Nov)	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	20.4	878.0	20.0	17.6	15.5	0.7%	14.3%	44.0	49.8	56.7	13.2%	13.9%	18.4	UP
Core Coverage														
D&O	0.67	671.3	34.4	32.1	16.3	0.7%	6.9%	19.5	20.9	41.1	81.0%	36.9%	0.73	MP
MPI	13.30	2791.7	15.2	16.3	15.0	2.0%	14.5%	183.3	171.2	186.0	-3.8%	8.6%	14.7	MP
NOTION	0.61	200.0	76.9	11.6	12.9	6.3%	5.3%	2.6	17.3	15.5	496.9%	-18.8%	0.73	MP
PIE	2.11	810.3	20.8	14.0	11.0	3.3%	14.7%	38.9	57.9	73.6	58.8%	27.1%	2.87	OP
SKPRES	2.03	2537.5	24.0	19.3	17.1	5.2%	26.4%	105.6	131.8	148.5	22.2%	12.6%	1.60	OP
UNISEM	3.68	2700.5	16.8	15.2	14.2	3.0%	12.1%	160.5	178.0	190.0	9.7%	6.7%	3.90	MP
Peer Average			31.4	18.1	14.4	3.4%	13.3%				110.8%	12.2%		

Source: Bloomberg, 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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