

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 UNDERPEROFM. 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 |

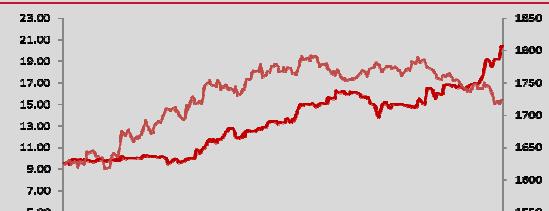
Major Shareholders

| | |
|--------------------|-------|
| 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



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

Lawrence Yeo Eng Chien
lawrenceyeo@kenanga.com.my
+603-2172 2653



24 November 2017

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.**

This report has been prepared by Kenanga Investment Bank Berhad pursuant to the Mid and Small Cap Research Scheme ("MidS") administered by Bursa Malaysia Berhad. This report has been produced independent of any influence from Bursa Malaysia Berhad or the subject company. Bursa Malaysia Berhad and its group of companies disclaim any and all liability, howsoever arising, out of or in relation to the administration of MidS and/or this report.

This document has been prepared for general circulation based on information obtained from sources believed to be reliable but we do not make any representations as to its accuracy or completeness. Any recommendation contained in this document does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may read this document. This document is for the information of addressees only and is not to be taken in substitution for the exercise of judgement by addressees. Kenanga Investment Bank Berhad accepts no liability whatsoever for any direct or consequential loss arising from any use of this document or any solicitations of an offer to buy or sell any securities. Kenanga Investment Bank Berhad and its associates, their directors, and/or employees may have positions in, and may effect transactions in securities mentioned herein from time to time in the open market or otherwise, and may receive brokerage fees or act as principal or agent in dealings with respect to these companies.

Published and printed by:

KENANGA INVESTMENT BANK BERHAD (15678-H)

Level 12, Kenanga Tower, 237, Jalan Tun Razak, 50400 Kuala Lumpur, Malaysia

Telephone: (603) 2172 0880 Website: www.kenanga.com.my E-mail: research@kenanga.com.my

This report is accessible at www.bursamids.com too.



Chan Ken Yew
Head of Research

