

01 June 2018

KESM Industries Bhd

A Short-Term Hiatus

9M18 missed on delay in sales amid wafer constraints as well as operational deleveraging. While this industry-wide disruption could continue to tax short-term prospect, 1H19 should recover with the shortfall in 2H18 to be made up by higher utilisation alongside capacity expansion. Despite earnings cut, we upgrade KESM to MP (after a rollover of TP of RM18.30) as we see attractive valuation after its deep correction and robust growth in FY19.

A short-term hiatus. A weaker-than-expected 3Q18 NP of RM5.5m (-51% QoQ; -48% YoY), brought 9M18 NP to RM28.0m (-8%) which only made up 56% of our/consensus full-year estimates. We attribute the shortfall to the industry-wide wafer shortage, which was observed among most OSAT players. Absence of dividend during the quarter was also expected.

YoY, 9M18 revenue grew by 7% driven by higher demand for its burn-in and testing services in 1H18. While EBITDA increased by 12%, operational profit dropped by 2% (with EBIT margin -1.1ppt to 12.9%), suggesting the ineffective charge-out of overhead cost which we attribute to 3Q18 operational deleveraging. Note that 3Q18 revenue decreased by 3%, with EBIT dropping further by 40% on weaker margin at 8.9% (-5.5ppt). With higher ETR of 16.9% (-4.2ppt), NP dropped by a wider 8%.

QoQ, 3Q18 sales compressed by 10% owing to lower utilisation. We gather that while not much order revisions were made from clients, production and delivery were delayed due to the industry-wide wafer shortages issues. With low operational efficiency alongside higher ETR of 24.4% (+4.2ppt), CNP came in much weaker at RM5.5m (-51%)

Growth to resume after a hiatus in 2H18. While this industry-wide disruption should continue to tax the group's short-term prospect, we are not overly concerned as we understand that the late delivery is only a timing issue with orders volume still resilient. Note that the group is still in its investment phase for customers, where it should continue to plough in a similar quantum of capex (FY17: RM107m) for expansion. Recall that FY17 revenue/CNP saw a jump of 18%/43% back then. In terms of investment, it is shifting towards upgrading existing plants in Malaysia and China into "smart factories", which should see higher automation hence better operational efficiency. All in, though we expect a weaker 2H18, recovery should be seen in 1H, underpinned by higher utilisation alongside capacity expansion.

Upgrade to MARKET PERFORM with a rollover TP of RM18.30 (from RM18.40). Post model updates, we cut our FY18E/FY19E by 17%/6% to account for the weaker 2H18 before a recovery in 1Q19. The group's share price has peaked off from RM22.20 to the latest closing of RM16.80 (-24%), which we see a better value proposition with it trading at a 2-year Fwd. PER of 13.8x (a discount of 14% compared to the industry 2-year Fwd. PER of 16.0x). With a rollover TP of RM18.30 (after earnings revision) to FY19 (from CY18), we upgrade the stock to MARKET PERFORM with its investment merits being its unique position in the stable automotive semiconductor business riding on (i) rising car production by global automakers, and (ii) increased chip content inside vehicles.

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

MARKET PERFORM ↑

Price: RM16.80
Target Price: RM18.30 ↓

Expected Capital Gain: +RM1.50 +8.9%
Expected Divd. Yield: +RM0.12 +0.7%
Expected Total Return: +RM1.62 +9.6%

KLCI Index 1,740.62

Stock Information

Bloomberg Ticker	KESM MK Equity
Bursa Code	9334
Listing Market	Main Market
Shariah Compliant	Yes
Shares Outstanding	43.0
Market Cap (RM m)	722.6
Par value per share (RM)	1.00
52-week range (H)	22.70
52-week range (L)	13.34
Free Float	41%
Beta	1.4
3-mth avg daily vol:	80,882

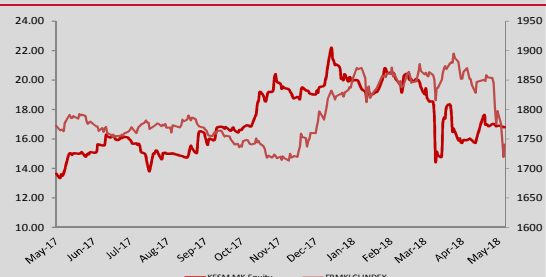
Major Shareholders

Sunright Ltd	48.4%
Kumpulan Wang Persaraan	5.7%
Tan Kong Hong Alex	4.8%

Summary Earnings Table

FY July (RM m)	2017A	2018E	2019E
Revenue	338.0	364.8	411.1
EBIT	47.8	47.1	61.3
PBT	47.8	47.0	60.6
Net profit	44.0	41.3	53.3
Core Net Profit	44.0	41.3	53.3
Consensus (NP)	-	48.5	58.8
Earnings Revision	-	-17%	-6%
Core EPS (sen)	100.7	94.6	122.0
Core EPS growth (%)	31.6	-6.1	28.9
DPS (sen)	12.5	11.7	15.1
BV/Share (RM)	7.5	8.2	9.3
Core PER	16.7	17.8	13.8
PBV (x)	2.2	2.0	1.8
Net. Gearing	-0.2	-0.2	-0.2
Div. Yield (%)	0.7	0.7	0.9

Share Price Performance



	1 mth	3 mths	12 mths
Absolute (%)	5.5%	-18.0%	24.4%
Relative (%)	12.5%	-11.8%	25.9%

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Results Highlights

	3Q	2Q	QoQ	3Q	YoY	9M	9M	YoY
FYE July (RM'm)	FY18	FY18	Chg	FY17	Chg	FY18	FY17	Chg
Revenue	82.3	91.5	-10.0%	85.0	-3.1%	264.5	248.2	6.6%
EBITDA	27.0	32.8	-17.5%	29.8	-9.4%	92.7	83.0	11.7%
EBIT	7.3	13.2	-44.6%	12.2	-40.2%	34.1	34.7	-1.6%
PBT	7.2	13.0	-44.4%	12.3	-40.9%	33.7	35.0	-3.8%
Taxation	-1.8	-1.8	-4.3%	-1.6	7.2%	-5.7	-4.4	28.3%
PAT	5.5	11.2	-51.1%	10.6	-48.4%	28.0	30.6	-8.4%
Net Profit	5.5	11.2	-51.1%	10.6	-48.4%	28.0	30.6	-8.4%
EPS (sen)	12.7	26.0	-51.2%	24.7	-48.6%	65.1	71.1	-8.4%
DPS (sen)	0.0	0.0		0.0		0.0	0.0	
EBITDA margin	32.8%	35.8%		35.1%		35.0%	33.4%	
EBIT margin	8.9%	14.4%		14.4%		12.9%	14.0%	
PBT margin	8.8%	14.2%		14.4%		12.7%	14.1%	
PATAMI margin	6.6%	12.2%		12.5%		10.6%	12.3%	
Effective tax rate	-24.4%	-14.2%		-13.4%		-16.9%	-12.7%	

Source: Company, 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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