

07 June 2019

KESM Industries Bhd

Winter Continues

KESM registered a CNL of RM0.5m in 3Q19, pulling back 9M19 CNP to RM2.6m (-91% YoY), markedly below our forecast at 20% and consensus estimate at 23% due to the trade war and WLTP. YoY, 9M19 revenue dropped 11% while 3Q19 revenue fell 9% due to slower demand for its burn-in and testing services. No dividend, as expected. Trim FY19-20E CNPs by 11-3% to RM11.5-20.1m. Upgrade to MP with a lower TP of RM7.00.

Markedly below expectations. KESM Industries (KESM) registered a Core Net Loss (CNL) of RM0.5m in 3Q19, pulling back 9M19 Core Net Profit (CNP) to RM2.6m (-91% YoY). This was markedly below our forecast at 20% and consensus estimate at 23%. We attribute the earnings miss to the Chinese imposition of tariffs on US vehicles and the introduction of the Worldwide Harmonised Light Vehicle Test Procedure (WLTP) emission regulation, both of which affected vehicle sales in the regions during the quarter. No dividend was announced during the quarter, as expected.

YoY, 9M19 revenue dropped 11% due to slower demand for its burn-in and testing services. We believe this could be a negative spillover from the US-China trade war and WLTP as noted, causing its utilization rate to fall below 50% as the group's customers instituted tighter inventory control measures. While EBITDA declined 31% on higher raw material costs (+45%), operating profit dropped by a larger quantum of 82%, suggesting the ineffective charge-out of overhead cost on weaker top-line. Coupled with a higher effective tax rate (ETR) of 43% (vs.17% in 9M18), CNP tumbled 91%. **QoQ**, 3Q19 revenue fell 9%, while the bottom-line reversed a CNP of RM0.5m to a CNL of RM0.5m due to higher material costs (+75%). The increase in raw material purchases coincided with the provision of electronics manufacturing services (EMS) to the group's new customers.

Lacking near-term catalysts. For 2HCY19, management prefers to remain cautious and avoid overspending as it believes automotive demand will remain sluggish and the next semiconductor upturn will only be seen at end-2019 earliest. We concur with management's view, as we see no major catalyst in the automotive sub-segment for the near term. However, long-term growth prospects of the group remain positive due to rising semiconductor content in vehicles. We also draw some comfort from KESM's sturdy balance sheet with net cash standing at RM118m as at end-3Q19 (up from RM116m at end-2Q19), positioning the group well to weather through the momentary market softness. The group is currently working on new product qualifications for end-products such as car cameras and sensors for park-assist.

Trim FY19-20E CNP by 11-3% to RM11.5-20.1m after lowering our EBIT margin assumptions from 4.5-6.0% to 4.0-5.9%.

Upgrade to MARKET PERFORM with a lower Target Price of RM7.00 (from RM7.20), based on FY20E PER of 15.0x, implying -0.5SD. While the weakness in the automotive market continues to dampen KESM's near-term prospects, the group's long-term outlook remains promising. Additionally, we believe most negatives have been priced-in at the current price levels.

Risks to our call include: (i) earlier/later-than-expected recovery in vehicle sales and (ii) slower/faster-than-expected adoption of new semiconductor modules in automobiles.

MARKET PERFORM ↑

Price: RM7.00
Target Price: RM7.00 ↓

Expected Capital Gain: +RM0.000 +0.0%
Expected Divd. Yield: +RM0.185 +2.6%
Expected Total Return: +RM0.185 +2.6%

KLCI Index 1,644.09

Stock Information

Bloomberg Ticker	KESM MK Equity
Bursa Code	9334
Listing Market	Main Market
Shariah Compliant	No
Shares Outstanding	43.0
Market Cap (RM m)	301.1
Par value per share (RM)	1.00
52-week range (H)	18.40
52-week range (L)	6.99
Free Float	40%
Beta	1.7
3-mth avg daily vol:	37,636

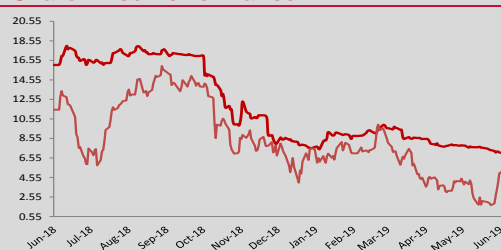
Major Shareholders

Sunright Ltd	48.4%
Kumpulan Wang Persaraan Diperbadankan	6.5%
Tan Kong Hong Alex	4.8%

Summary Earnings Table

FY July (RM m)	2018A	2019E	2020E
Revenue	349.8	315.5	363.0
EBIT	44.0	12.7	21.4
PBT	43.7	12.8	22.3
Net profit	39.3	11.5	20.1
Core Net Profit	39.3	11.5	20.1
Consensus (NP)	N.A.	11.1	23.3
Earnings Revision	N.A.	-11%	-3%
Core EPS (sen)	91.5	26.8	46.6
Core EPS growth (%)	-10.6	-70.7	74.3
DPS (sen)	18.5	18.5	18.5
BV/Share (RM)	8.2	8.2	8.5
Core PER	7.7	26.2	15.0
PBV (x)	0.8	0.8	0.8
Net. Gearing	-0.3	-0.4	-0.4
Div. Yield (%)	2.6	2.6	2.6

Share Price Performance



	1 mth	3 mths	12 mths
Absolute (%)	-10.4%	-26.3%	-56.5%
Relative (%)	-10.8%	-23.4%	-50.2%

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Results Highlights

	3Q	2Q	QoQ	3Q	YoY	9M	9M	YoY
FYE July (RM'm)	FY19	FY19	Chg	FY18	Chg	FY19	FY18	Chg
Revenue	73.8	81.1	-9.0%	82.3	-10.4%	236.5	264.5	-10.6%
EBITDA	20.2	20.7	-2.5%	27.0	-25.2%	64.0	92.7	-30.9%
EBIT	1.2	1.3	-1.9%	7.3	-83.0%	6.0	34.1	-82.4%
PBT	1.6	1.6	-3.0%	7.2	-78.0%	7.0	33.7	-79.1%
Taxation	-0.7	-1.2	-38.1%	-1.8	-59.0%	-3.0	-5.7	-46.4%
Net Profit	0.9	0.5	83.5%	5.5	-84.1%	4.0	28.0	-85.8%
Core Net Profit	-0.5	0.5	NM	5.5	NM	2.6	28.0	-90.6%
EPS (sen)	2.0	1.1	81.8%	12.7	-84.3%	9.2	65.1	-85.9%
DPS (sen)	0.0	0.0	NM	0.0	NM	0.0	0.0	
EBITDA margin	27.4%	25.6%		32.8%		27.1%	35.0%	
EBIT margin	1.7%	1.6%		8.9%		2.5%	12.9%	
PBT margin	2.2%	2.0%		8.8%		3.0%	12.7%	
PATAMI margin	-0.6%	0.6%		6.6%		1.1%	10.6%	
Effective tax rate	-45.4%	-71.2%		-24.4%		-43.3%	-16.9%	

Source: Company, Kenanga Research

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Malaysian Technology Peers Comparison

Name	Last Price (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div Yld (%)	Target Price (RM)	Rating
					1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.		
D&O GREEN TECHNOLOGIES BERHAD	0.620	686.9	Y	12/2019	7.5%	15.6%	18.1%	26.0%	19.0	17.2	14.6	2.2	2.2	12.5%	1.8%	0.650	MP
KESM INDUSTRIES BERHAD	7.00	301.1	N	07/2019	-9.8%	15.1%	-70.7%	74.3%	7.7	26.2	15.0	0.8	0.8	3.2%	2.6%	7.00	MP
MALAYSIAN PACIFIC INDUSTRIES BHD	8.79	1,748.3	N	06/2019	8.1%	5.3%	16.0%	5.8%	10.2	8.8	8.3	1.5	1.4	13.6%	3.5%	12.10	OP
P.I.E. INDUSTRIAL BERHAD	1.27	487.7	Y	12/2019	10.4%	6.2%	1.4%	13.0%	11.5	11.4	10.0	1.2	1.1	9.9%	3.9%	1.55	OP
SKP RESOURCES BHD	1.29	1,612.7	Y	03/2020	28.5%	15.2%	30.4%	13.3%	16.6	12.8	11.3	2.7	2.5	20.3%	4.0%	1.40	OP
UNISEM (M) BERHAD	2.52	1,832.3	Y	12/2019	1.7%	8.0%	3.6%	29.5%	19.2	18.6	14.4	1.3	1.3	6.8%	3.6%	2.15	UP

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%

**** The Expected Total Return might contain rounding discrepancy.**

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

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Published and printed by:

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