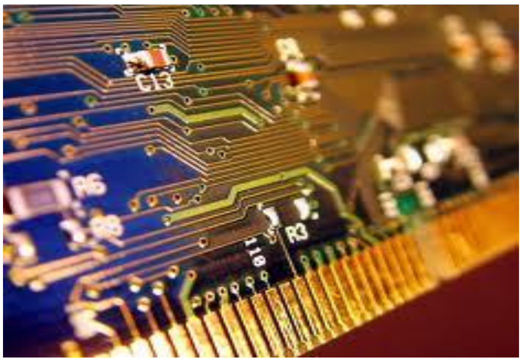
Technology

Nap Time is Over

OVERWEIGHT
↔

By Adrian Kok l adrian.kok@kenanga.com.my

We reiterate our OVERWEIGHT stance on the technology sector as the environment appears conducive for a recovery in 4Q19, with outlook for both smartphone and automotive segments turning more encouraging, while valuations remain undemanding. Trading interests could return to the smartphone space as early signs show that demand for Apple's trio of iPhone 11 models are stronger than expected. In the automotive segment, we are seeing possible signs of recovery in major markets such as (i) China, backed by friendly initiatives such as tax cuts for rural consumers and lifting of licence plate quota in Guangzhou and Shenzhen, and (ii) Europe, which has already seen positive growth in July 2019. In the EMS space, prospects for SKPRES remain promising as it continues to see contracts driven by its major customers' shift to newer models, while PIE is expected to benefit from the relocation of manufacturing facilities from China. Overall, with a potential turn in the tide for the technology sector, while valuations remain undemanding, we reckon it is opportune to revisit the technology sector. Our top picks are MPI (OP, TP: RM12.10) and KESM (OP, TP: RM8.70).



Time to revisit. We reiterate our OVERWEIGHT stance on the technology sector as the environment appears conducive for a recovery in 4Q19, with outlook for both smartphone and automotive segments turning more encouraging, while valuations remain undemanding. To capitalise on this potential recovery, our preferred picks are MPI (OP, TP: RM12.10) and KESM (OP, TP: RM8.70).

Smartphone segment regaining limelight. We see trading interests potentially returning to the smartphone space within the semiconductor industry in 4Q19 as outlook turns positive. Apple has just launched a trio of its flagship smartphone models – iPhone 11, iPhone 11 Pro and iPhone 11 Pro Max – featuring camera upgrade (triple-camera system for the Pro versions), better battery life and cheaper pricing for entry-level iPhone 11 (US$50 cheaper than its predecessor iPhone XR). Thus far, early reports suggest that the phones are receiving stronger-than-expected response, even in China, which in our view is not a total surprise as most consumers anecdotally pay more attention to camera quality rather than connectivity. Besides, the launch also coincides with the smartphone replacement cycle of 2-3 years (Note: 2016 and 2017 iPhone generations did remarkably well). According to Reuters, JD.com said that pre-orders for the iPhone 11 series skyrocketed 480% compared to last year, while Alibaba's Tmall saw 335% jump in the pre-sales of iPhone 11 on the first day vs. that of the iPhone XR. News of TSMC seeing strong demand for its 7nm technology (adopted in the iPhone 11 series' A13 Bionic processor), as reported by Digitimes, also serves as corroboration for the sturdy iPhone presales.

We also see serendipity from the Huawei Android ban, as less tech-savvy and conservative customers may gravitate towards, inter alia, Apple or Samsung to avoid the inconvenience of not being able to use Google services (such as YouTube and Gmail). This has positive implications for our local semiconductor players as their prospects are more closely tied to the Korean and North American smartphone players. Last but not least, there is a possibility that fabless companies would hoard inventory ahead of another round of 15% tariff imposition in December on an item list that includes cell phones, possibly resulting in pent-up demand for smartphone-related semiconductor in 4Q19. Even in the event that a trade war resolution is reached between the US and China before that, sentiment for the sector would likely be resuscitated. In other words, either way, we see limited risks in taking positions in smartphone-exposed OSAT players in 4Q19. Within our coverage, companies with meaningful smartphone exposure are MPI and UNISEM (33% and 25% of revenue in 2QCY19, respectively), but we are maintaining our MARKET PERFORM call on UNISEM on valuation grounds.

Worldwide Smartphone Sales to End Users by Vendor (m of units)

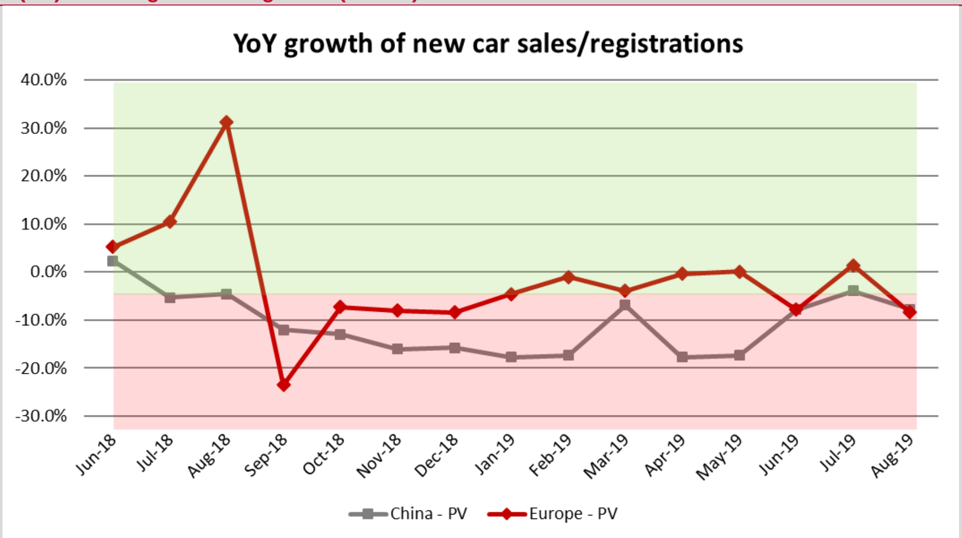
	Shipments (units)			Growth		Market Share		
Company	**2Q19**	**1Q19**	**2Q18**	**QoQ**	**YoY**	**2Q19**	**1Q19**	**2Q18**
Samsung	75.1	71.6	72.3	4.9%	3.8%	20%	19%	19%
Huawei	58.1	58.4	49.8	-0.7%	16.5%	16%	16%	13%
Apple	38.5	44.6	44.7	-13.6%	-13.8%	10%	12%	12%
Oppo	28.1	29.6	28.5	-5.0%	-1.4%	8%	8%	8%
Others	168.1	168.8	178.9	-0.4%	-6.0%	46%	45%	48%
Total	**367.9**	**373.0**	**374.3**	**-1.4%**	**-1.7%**	**100%**	**100%**	**100%**

Source: Gartner

Light at the end of the tunnel for the automotive market. We are seeing possible signs of recovery in major automotive markets like China and the Europe in 4Q19. In Europe, passenger car registrations have already seen positive growth in July 2019 (+1.4% YoY), an encouraging sign of recovery for the region's automotive market. Note that the decline in August 2019 (-8.4% YoY) was attributed to a high base in August 2018 (+31.2% YoY) as the month saw exceptional growth ahead of the introduction of the Worldwide Light Vehicles Test Procedure (WLTP) on 1 September 2018. Going forward, we believe passenger car registrations would start picking up, especially considering the low bases in September-December 2018. Meanwhile, in China, passenger vehicle sales are likely to return to the growth trajectory post-conclusion of the VI emission standards in July 2019, further boosted by a series of friendly policies such as tax cut for rural consumers, fees reduction and lifting of licence plate quota in Guangzhou and Shenzhen. For the long term, prospects of the automotive-centric semiconductor players are also promising. Market research firm IC Insights forecasts automotive semiconductor market to be the strongest end-market for electronic chips through 2021, with 5-year CAGR of 5.4%, underpinned by: (i) rising demand for electronic systems in vehicles to power autonomous driving, vehicle-to-vehicle and vehicle-to-infrastructure communications; as well as (ii) on-board safety, convenience and environmental features.

D&O and KESM are prime proxies for the automotive market recovery. To capitalise on the automotive market recovery and its exciting long-term prospects, we recommend taking positions in D&O (OP; TP: RM0.625) and KESM (OP; TP: RM8.70) given their automotive-centric portfolio (>90% and >80% of revenue, respectively). Apart from the duo, our outsourced semiconductor assembly and test (OSAT) players (MPI and Unisem) have also been realigning their portfolios in the past 1-2 years with capex skewing towards the automotive segment (e.g. sensors packaging, advanced vehicle safety systems). MPI (OP; TP: RM12.10) has shown increased contribution from automotive sensor-related packaging products with 32% share in 2QCY19 vs. 24-25% in FY17, and it targets to grow this to 50% in 2-3 years. For UNISEM (MP; TP: RM2.05), its contribution from the automotive segment has been stable at 15-18% in the past few years, but is set to grow larger going forward given its ties with one of the key players in tyre pressure monitoring system (TPMS). TPMS should see increasing market penetration over the next few years as China has made it compulsory for all new M1 vehicles to carry TPMS by 2019.

Passenger vehicle (PV) sales/registrations growth (% YoY)



Source: CAAM, ACEA

5G to be a valuation kicker. We look forward to more commercial launches of 5G worldwide as it will not only drive the offtake of existing products (especially those relating to data infrastructure, radio frequency and sensors) but also lead to the creation of new/next-generation products and services. The second 3GPP standard for 5G network (Release-16 or 5G Phase 2), which is due for release in March 2020, will further define specifications related to Vehicle-to-everything (V2X) communications, and Local Area Network support in 5G and broader applications of Internet of Things (IoT) technologies. This paves the way for the development of connected/autonomous vehicles and smart/automated factories, which would in turn drive the offtake of RF and sensor devices in 2020. We believe this would augur well for MPI (OP; TP: RM12.10) and Unisem (MP; TP: RM2.05), which provide RF testing and sensor packaging solutions.

In the EMS space, prospects for SKPRES remain promising as it continues to secure contracts driven by its major customers' shift to newer, evolutionary models. Additionally, the group's first PCBA line has commenced in April 2019, paving the way for more contracts given the key customer's emphasis for its contract manufacturers to be vertically integrated. Meanwhile, for PIE, its existing telecommunication, industrial printing, medical and raw cable customers should continue to see growth in sales volume in FY19. In addition, both the companies recently saw an influx of enquiries from companies that are looking to shift their supply chain out of China, which could translate into business opportunities in the near term.

Reiterate OVERWEIGHT stance on the technology sector. Overall, with a potential turn of the tide in the technology sector, while current valuations remain undemanding, we reckon it is opportune to revisit the technology sector. Our top picks are:

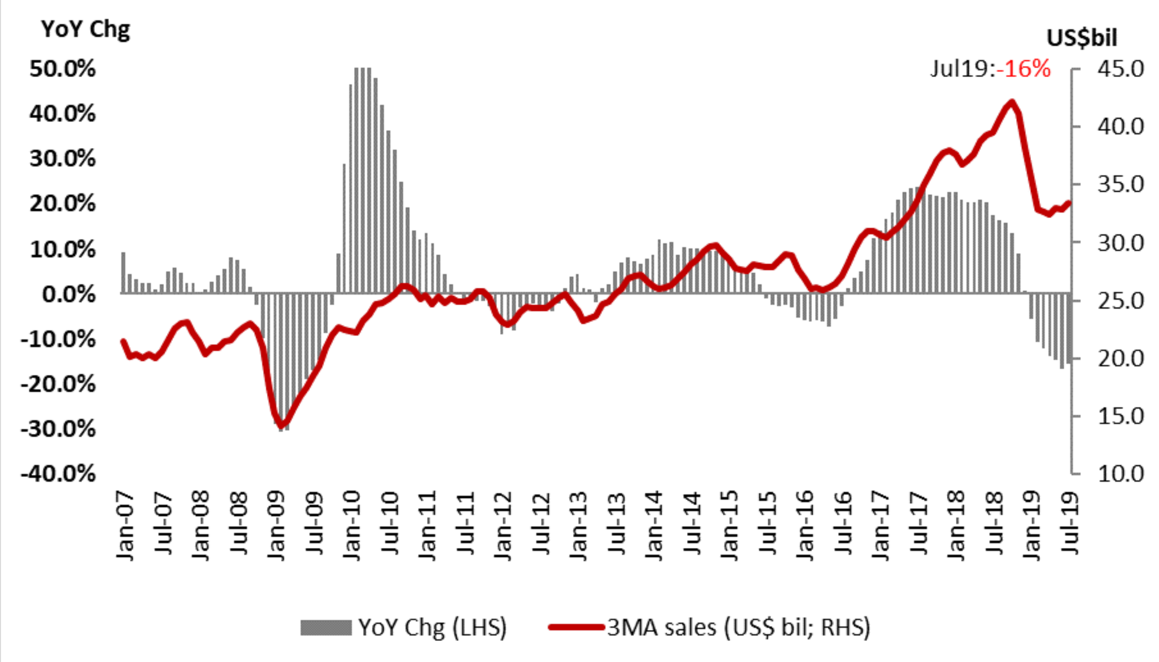
(i) **MPI (OUTPERFORM, TP: RM12.10).** Earnings momentum is looking positive with 1Q20 potentially posting QoQ growth on the back of a full pipeline of new product introductions (NPIs) earlier, while 2Q20 is likely to be further boosted by contributions from multiple newly acquired customers for Suzhou plant, which is already running at 93% capacity and is currently undergoing major expansion (Suzhou currently contributes c.30% of group revenue and is expected to climb to 50% later). Potential re-inclusion into the Shariah-compliant list in November is also a catalyst. These positive prospects are juxtaposed with an unjustifiably low ex-cash PE of 6x.

(ii) **KESM (OUTPERFORM, TP: RM8.70).** We believe KESM's performance will pick up in 1H20 along with the automotive market recovery, while its long-term prospects are also promising with rising semiconductor content in automobiles. Having corrected >60% from the 52-week high of RM18.20 (on 8 August 2018), KESM's current share price (RM7.23 as of 20 September 2019) appears highly attractive, implying only 15.1x vs. its historical mean of c.18.0x.

Meanwhile, we upgrade:

(i) **Upgrade SKPRES to OUTPERFORM from MARKET PERFROM with an unchanged target price of RM1.15** based on an unchanged FY20 PER of 13x. Since June 2019, SKPRES' share price has retraced 22% and at current price of RM1.04 *(cut-off date 20-Sep-19)*, it is trading at Fwd. PER of only 11.6x (vs. its closest peers' average of 13.7x) which we believe is unjustified. With an expected pick-up in subsequent quarters' earnings on contributions of its new model variant under its conventional electrical appliances and its customers' seasonal ramp-up ahead of the festive season, we opine that downside is fairly limited. Additionally, among its closest peers, SKPRES pays the highest quantum of dividend (50% payout) translating into decent FY20-21E dividend yield of 4.3-5.1%, which should cushion share price.

Global Semiconductor Sales and YoY growth



Source: SIA, Kenanga Research

WSTS Semiconductor Sales Forecasts by Product Type (Spring 2019 Q2 update)

	US$ bil				YoY %			
	2017	2018F	2019F	2020F	2017	2018F	2019F	2020F
Discrete Semiconductors	**21.7**	**24.1**	**24.1**	**25.3**	*4.3*	*11.3*	*0.1*	*4.7*
Optoelectronics	**34.8**	**38.0**	**39.8**	**43.1**	*-3.8*	*9.2*	*4.8*	*8.2*
Sensors	**12.6**	**13.4**	**13.4**	**14.1**	*22.7*	*6.2*	*0.6*	*4.8*
Integrated Circuits	**343.2**	**393.3**	**329.2**	**343.6**	*0.8*	*14.6*	*-16.3*	*4.4*
Analog	53.1	58.8	53.6	55.6	*5.8*	*10.8*	*-8.8*	*3.7*
Micro	63.9	67.2	63.5	64.9	*-1.2*	*5.2*	*-5.6*	*2.3*
Logic	102.2	109.3	103.0	108.0	*0.8*	*6.9*	*-5.8*	*4.9*
Memory	124.0	158.0	109.1	115.1	*-0.6*	*27.4*	*-31.0*	*5.5*
Total	**412.2**	**468.8**	**406.6**	**426.1**	*1.1*	*13.7*	*-13.3*	*4.8*

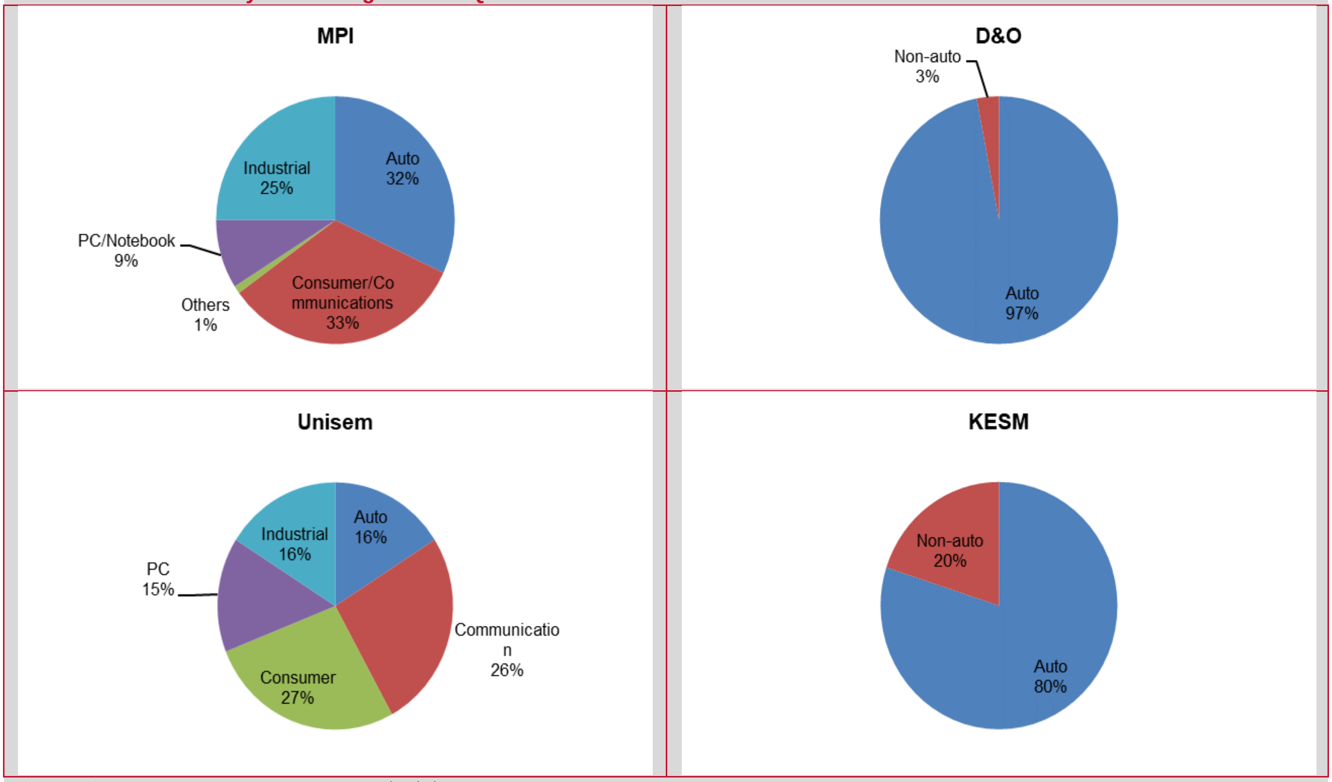
Source: WSTS

Worldwide Device Shipments by Device type, 2018-2021 (Millions of Units)

Device Type	Shipments (million of units)				YoY growth			
	2018	2019F	2020F	2021F	2018	2019F	2020F	2021F
Traditional PCs (Desk-Based and Notebook)	195	187	178	171	-7%	-4%	-5%	-4%
Ultramobile (Premium)	64	70	75	81	16%	8%	8%	8%
PC Market	**260**	**257**	**253**	**253**	**-3%**	**-1%**	**-2%**	**0%**
Ultramobiles (Tablets and Clamshells)	150	146	145	142	-7%	-2%	-1%	-2%
Computing Devices Market	**409**	**403**	**397**	**395**	**-4%**	**-2%**	**-1%**	**-1%**
Mobile Phones	1,812	1,745	1,771	1,763	-3%	-4%	1%	0%
Total Devices Market	**2,221**	**2,149**	**2,168**	**2,158**	**-3%**	**-3%**	**1%**	**0%**

Source: Gartner

Revenue breakdown by market segment in 2QCY19



Source: Company, Kenanga Investment Bank Bhd

Malaysian Technology Peers Comparison

Name	Last Price @ 20/9/19 (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 BHD	0.575	639.2	Y	12/2019	3.7%	10.5%	22.2%	21.8%	21.7	19.0	16.7	2.1	2.1	10.6%	1.9%	0.625	OP
KESM INDUSTRIES BERHAD	7.23	311.0	N	07/2020	-9.8%	15.1%	-70.7%	74.3%	7.9	27.0	15.5	0.9	0.9	3.2%	2.6%	8.70	OP
MALAYSIAN PACIFIC INDUSTRIES BHD	9.11	1,811.9	N	06/2020	5.0%	5.0%	25.4%	4.6%	13.5	10.8	10.3	1.7	1.6	12.2%	3.6%	12.10	OP
P.I.E. INDUSTRIAL BERHAD	1.19	457.0	Y	12/2019	5.5%	7.3%	-7.5%	16.2%	10.8	11.7	10.0	1.1	1.0	9.1%	4.2%	1.20	MP
SKP RESOURCES BHD	1.04	1,300.2	Y	03/2020	18.9%	14.1%	16.0%	17.1%	13.4	11.6	9.9	2.2	2.0	18.2%	4.3%	1.15	OP
UNISEM (M) BERHAD	2.01	1,461.4	Y	12/2019	-6.8%	2.7%	-25.5%	31.4%	15.3	20.7	15.7	1.0	1.0	4.9%	3.0%	2.05	MP

Source: Kenanga Research

This section is intentionally left blank

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.***

Published and printed by:

KENANGA INVESTMENT BANK BERHAD (15678-H)
Level 17, 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