

20 September 2017

KESM Industries Bhd

10th straight quarterly revenue increase

KESM posted its 4Q17 earnings, which showed a 10th straight quarterly increase in revenue and the highest core net profit on record. The impressive results were driven largely by higher demand for burn-in and testing services, which have been matched by a marked increase in CAPEX in previous quarters. Going forward, we expect its prospects to remain upbeat with focus remaining on growing the testing business for automotive semiconductors. Post model adjustments, we upgrade our FY18E/FY19E NP estimates by 4.8%/3.8%. Maintain **OUTPERFORM** with a higher TP of RM18.40.

FY17 beat expectations. KESM reported 4Q17 net profit of RM13.4m, bringing the FY17 earnings to RM44.0m which was above our expectations/consensus by 7.8% and 10.5%, respectively. The positive result was attributed to stronger-than-expected margins due to better economies of scale and investment tax allowance in 4Q17. A higher than-expected dividend of 6.0 sen was proposed, which would bring FY17 NDPS to 12.5 sen.

Stronger sequential results. 4Q17 revenue grew 5.6% while net profit jumped 26.4% QoQ from RM10.6m to RM13.4m. The stronger top-line was due to the addition of testing machinery in prior quarters which allowed the Group to capitalize on the higher demand for burn-in and testing services. Meanwhile, investment tax allowance recorded during the quarter resulted in a tax benefit of RM0.6m compared to a tax expense of RM1.6m in 3Q17.

On a YoY comparison, 4Q16 revenue grew by 20.4% while net profit soared 66.6% for the same reasons mentioned above. In addition, a lower proportion of employee benefits expense (+7%) was more than enough to offset the higher depreciation (+31%) and increase in "raw materials and consumables used" (+37%) which is typical of the low margin EMS business. **YTD, FY17** revenue increased 18.3% while net profit rose 43.4% from RM30.7m to RM44.0m. Increased revenue aside, EBIT margins expanded 1.3ppt, aided by a lower proportion of employee benefits expenses (+14%) while a lower effective tax rate of 8.0% (-7.3ppt) lifted net margin to 13.0% (+2.3ppt).

Expansion plans to continue. Note worthy, commentaries in KESM's FY17 financial statement indicated that the Group acquired PPE amounting to RM140.2m, of which RM107.1m was already reflected in the cash flow statement. Indeed, KESM has achieved a record year on capital investment spending in FY17, which far exceeds the RM30m spent in FY16. We understand that the current pace in CAPEX is likely to continue into the immediate quarters ahead, catering to the increased demand from the Group's existing clients. Focus remains on testing equipments for automotive semiconductors, which represent an area of high growth, driven by rising car production by global automakers and increased chip content within vehicles.

Increasing estimates! Post earnings release, we adjust our CAPEX assumptions for FY18 to RM120m from RM80m as we take into account the current trajectory of expansion within the testing business. Consequently, we raise our revenue forecasts. At the same time, we factor in a lower effective tax rate to account for the increased investment tax allowance and hence FY18E/FY19E net profits are upped by 4.8%/3.8% to RM49.8m/RM56.7m.

Maintain OUTPERFORM with a higher TP of RM18.40. Post model updates, we derive a higher target price with an unchanged target PER of 15x over CY18E EPS. Our valuation comes in-line with local OSAT players MPI and UNISEM, both of which we have assigned up-cycle valuations in view of the industry's recovery and favourable macro-economic factors. Risks to our call include: (i) lower-than-expected sales and margins, and (ii) longer-than expected gestation periods.

OUTPERFORM ↔

Price: **RM15.06**
Target Price: **RM18.40** ↑

Expected Capital Gain: **RM3.34 +22.2%**
Expected Divd. Yield: **RM0.14 +0.9%**
Expected Total Return: **RM3.48 +23.1%**

KLCI Index **1,776.66**

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)	647.8
Par value per share (RM)	1.00
52-week range (H)	16.30
52-week range (L)	7.52
Free Float	42%
Beta	0.4
3-mth avg daily vol:	59,774

Major Shareholders

Sunright Ltd	48.4%
Wong Tee Fatt	5.0%
Tan Kong Hong Alex	4.8%

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)	-	48.6	58.6
Earnings Revision	-	+4.8%	+3.8%
Core EPS (sen)	100.7	114.0	129.8
Core EPS growth (%)	28.8	13.2	13.9
DPS (sen)	0.0	14.0	16.0
BV/Share (RM)	7.5	8.4	9.5
Core PER	15.4	13.7	12.0
PBV (x)	2.1	1.9	1.6
Net. Gearing	-0.1	-0.3	0.7
Div. Yield (%)	0.0	1.1	1.3
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 (%)	-6.8%	-20.2%	2.0%
Relative (%)	-6.9%	-20.0%	-3.0%

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Results Highlights

	4Q	3Q	QoQ	4Q	YoY	12M	12M	YoY
FYE July (RM'm)	FY17	FY17	Chg	FY16	Chg	FY17	FY16	Chg
Revenue	89.8	85.0	5.6%	74.5	20.4%	338.0	285.7	18.3%
EBITDA	31.5	29.8	5.7%	23.4	34.9%	114.5	92.0	24.5%
EBIT	13.1	12.2	7.0%	9.3	40.3%	47.8	36.7	30.1%
PBT	12.8	12.3	4.6%	9.4	36.8%	47.8	36.2	32.0%
Taxation	0.6	-1.6	-135.5%	-1.3	-144.1%	-3.8	-5.6	-30.7%
PAT	13.4	10.6	26.4%	8.0	66.6%	44.0	30.7	43.4%
Net Profit	13.4	10.6	26.4%	8.0	66.6%	44.0	30.7	43.4%
EPS (sen)	31.2	24.7	26.4%	18.7	66.6%	102.3	71.3	43.4%
DPS (sen)	0.0	6.5		0.0		6.5	7.5	
EBITDA margin	35.1%	35.1%		31.4%		33.9%	32.2%	
EBIT margin	14.6%	14.4%		12.5%		14.1%	12.9%	
PBT margin	14.3%	14.4%		12.6%		14.2%	12.7%	
PATAMI margin	14.9%	12.5%		10.8%		13.0%	10.7%	
Effective tax rate	4.6%	-13.4%		-14.2%		-8.0%	-15.3%	

Source: Company, Kenanga Research

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Peer Comparison

NAME	Price (19-Sept)	Mkt Cap (RMm)	PER (x) Historical	PER (x)		Est. Div. Yld.	Fwd ROE	Net Profit (RMm)			1Y Fwd Growth (%)	2Y Fwd Growth (%)	Target Price (RM)	Rating
	(RM)			1Y Fwd	2Y Fwd			Historical	1Y Fwd	2Y Fwd				
KESM	15.06	647.6	21.4	13.2	11.6	0.9%	13.6%	44.0	49.8	56.7	13.2%	13.9%	18.40	OP
Core Coverage														
MPI	13.8	2,896.4	16.3	14.6	13.9	2.0%	13.3%	177.9	198.7	208.4	11.7%	4.9%	15.7	OP
UNISEM	3.85	2,825.1	17.4	16.1	15.0	2.6%	12.0%	162.3	175.7	188.3	8.3%	7.2%	3.85	MP
NOTION	1.01	331.1	61.3	13.0	9.4	3.8%	7.7%	5.4	25.4	35.2	370.4%	38.6%	1.55	OP
SKPRES	1.47	1,806.6	17.3	13.7	12.2	6.8%	26.4%	104.5	131.8	148.5	26.1%	12.7%	1.60	OP
PIE	2.31	887.1	24.3	13.4	12.1	4.3%	16.7%	36.5	66.4	73.6	81.9%	10.8%	2.87	OP
Peer Average			27.3	14.2	12.5	3.9%	15.2%				99.7%	14.8%		

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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Published and printed by:

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