

09 March 2018

KESM Industries Bhd

Expansion Spree Resumes After Hiatus

KESM registered the 12th consecutive quarterly increase in revenue and commendable earnings performance (+12.2 YoY, -1.7% QoQ) which met expectations. CAPEX has resumed after a brief hiatus in the previous quarter and although we like KESM for its unique position in the high growth automotive semiconductor business, valuations remain rich – necessitating our UNDERPERFORM rating and unchanged TP at RM18.40 at 15x CY18E PER.

1H18 earnings meet expectations. At 45.3%/44.0% of house/street's estimates, we deem KESM's 1H18 net profit of RM22.6m to be in-line with expectations as earnings should pick up in the second half amid a gradual ramp up in testing capacities from FY17's blowout expansion year. Absence of dividends during the quarter was also expected, although we expect full-year dividend to total 14.0 sen subsequently.

12th sequential improvement in quarterly revenue. 2Q18 revenue grew marginally by 0.8% QoQ to RM91.5m while net profit declined by 1.7% to RM11.2m. 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 for burn-in and testing services. However, KESM's bottom-line was slightly lower due to higher depreciation expense as additional machinery and test equipment were commissioned for production.

On a YoY comparison, 2Q18 revenue grew by 10.1%, driven by higher demand for burn-in and testing services. Meanwhile, net profit rose to RM11.2m (+12.1% YoY) as a smaller proportion of low margin EMS services (relative to the higher margin testing services) was able to offset the increase in depreciation expense (+22%) and other expenses (+18%) such as repairs, maintenance, utilities and management fees.

1H18 revenue grew by 11.6% YoY to RM182.2m for the same reasons mentioned above. Furthermore, EBITDA increased by a larger quantum of 23.6% (EBITDA margins expanded +3.5ppt to 36.0%) although the effects were subsequently watered down by the increase in depreciation expense (+27%), other expense (+17%) and higher effective tax rate of 14.8% (+2.6ppt). Consequently, 1H18 net profit came in at RM22.6m (+12.8%) while net margin only improved slightly to 12.4% (+0.1ppt).

CAPEX resumes after brief hiatus in 1Q18. KESM has resumed its expansion plans after a breather in the previous quarter (2Q18: RM33.3m vs. 1Q18: RM13.5m) and we expect FY18 CAPEX to come in at RM120m. Focus, however, is shifting towards upgrading its existing plants in Malaysia and China into "smart factories". As car manufacturers that KESM serves are moving into designing cars that can communicate with other cars as well as street lights, we understand that these smart factories will go beyond just automation, and will also be providing real-time manufacturing information online, necessary for the test and burn-in of a new wave of complex semiconductors for the automotive industry.

Maintain TP of RM18.40 and UNDERPERFORM rating. 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. Despite the recent pullback in its share price, KESM is still trading at a rich valuations of 15.5x CY18E PER vs. our targeted PER of 15x – therefore necessitating our UNDERPERFORM call.

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

UNDERPERFORM ↔

Price: **RM19.50**
Target Price: **RM18.40** ↔

Expected Capital Gain: **-RM1.10 -5.6%**
Expected Divd. Yield: **RM0.14 +0.7%**
Expected Total Return: **-RM0.96 -4.9%**

KLCI Index **1,839.62**

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)	838.8
Par value per share (RM)	1.00
52-week range (H)	22.70
52-week range (L)	9.99
Free Float	43%
Beta	1.1
3-mth avg daily vol:	59,750

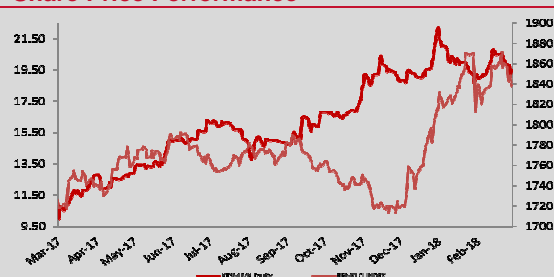
Major Shareholders

Sunright Ltd	48.4%
Tan Kong Hong Alex	4.8%
Oversea Chinese Bank	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	19.4	17.1	15.0
PBV (x)	2.6	2.3	2.0
Net. Gearing	-0.2	-0.2	-0.2
Div. Yield (%)	0.6	0.7	0.8

Share Price Performance



	1 mth	3 mths	12 mths
Absolute (%)	2.6%	3.4%	94.6%
Relative (%)	1.5%	-3.6%	87.5%

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Results Highlights

	2Q	1Q	QoQ	2Q	YoY	1H	1H	YoY
FYE July (RM'm)	FY18	FY17	Chg	FY17	Chg	FY18	FY17	Chg
Revenue	91.5	90.7	0.8%	83.1	10.1%	182.2	163.2	11.6%
EBITDA	32.8	32.9	-0.5%	27.5	19.1%	65.7	53.1	23.6%
EBIT	13.2	13.6	-3.1%	11.5	14.9%	26.8	22.5	19.3%
PBT	13.0	13.5	-3.2%	11.6	12.2%	26.5	22.8	16.3%
Taxation	-1.8	-2.1	-11.3%	-1.6	13.4%	-3.9	-2.8	40.8%
PAT	11.2	11.4	-1.7%	10.0	12.1%	22.6	20.0	12.8%
Net Profit	11.2	11.4	-1.7%	10.0	11.6%	22.6	20.0	12.8%
EPS (sen)	26.0	26.4	-1.7%	23.2	12.1%	52.4	46.5	12.8%
DPS (sen)	0.0	0.0		0.0		6.0	3.0	
EBITDA margin	35.8%	36.3%		33.1%		36.0%	32.6%	
EBIT margin	14.4%	15.0%		13.8%		14.7%	13.8%	
PBT margin	14.2%	14.8%		14.0%		14.5%	14.0%	
PATAMI margin	12.2%	12.5%		12.0%		12.4%	12.2%	
Effective tax rate	-14.2%	-15.5%		-14.0%		-14.8%	-12.2%	

Source: Company, Kenanga Research

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Peer Comparison

NAME	Price (8-Mar)	Mkt Cap (RMm)	PER (x)			Est. Div. Yld.	Fwd ROE	Net Profit (RMm)			1Y Fwd Growth (%)	2Y Fwd Growth (%)	Target Price (RM)	Rating
	(RM)		Historical	1Y Fwd	2Y Fwd			Historical	1Y Fwd	2Y Fwd				
KESM	19.50	839.3	19.1	16.9	14.8	0.7%	14.3%	44.0	49.8	56.7	13.2%	13.9%	18.4	UP
Core Coverage														
D&O	0.63	626.3	32.1	15.9	13.3	1.1%	12.3%	19.5	39.5	47.0	24.2%	19.0%	0.69	MP
MPI	8.62	1809.3	9.9	12.1	11.7	3.1%	12.8%	183.3	149.8	154.6	-15.8%	3.2%	9.7	UP
NOTION	0.67	219.9	18.6	-9.8	15.8	2.3%	-6.6%	11.8	-22.5	13.9	-278.6%	-161.8%	0.44	UP
PIE	1.57	602.9	14.4	11.3	9.6	4.1%	12.7%	42.0	53.4	63.1	11.3%	18.2%	2.1	OP
SKPRES	1.70	2125.0	20.1	15.7	12.5	3.2%	27.1%	105.6	135.6	169.9	25.8%	25.3%	2.05	OP
UNISEM	2.55	1871.3	11.8	12.6	11.5	4.3%	9.9%	158.0	148.8	162.4	-6.7%	9.1%	2.45	UP
Peer Average			17.8	9.6	12.4	3.0%	11.4%				-40.0%	-14.5%		

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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