

23 November 2018

KESM Industries Bhd

Below Expectations

1Q19 CNP missed expectations on weaker-than-expected revenue and further exacerbated by operational deleveraging. Though 2Q19 could continue to see weakness, structural growth from higher semiconductor content driven by increasing chips content in automobiles and autonomous driving development should support long-term prospect. Post earnings adjustment, TP lowered to RM10.20 (at 15.0x FY19E PER). Maintain MP.

Below expectations. A much weaker-than-expected 1Q19 CNP of RM2.6m (-77% QoQ, -77% YoY) was reported, which merely made up 5%/6% of our/consensus full-year estimates. The negative deviations were the weaker-than-expected revenue alongside operational deleveraging (with fixed cost unable to charge out effectively) which collectively compressed CNP margin to a mere 3.2% (from its usual teens level). Absence of DPS, however, was expected.

YoY, 1Q19 revenue dropped by 10% which we attribute to the slower demand for its burn-in and testing services. We believe this could be a negative spillover from the US-China trade war, which have prompted its customers to be more prudent on inventory take-up. While EBITDA dropped 30% on higher raw material costs (+17%), operating profit dropped by a wider quantum of 74%, suggesting the ineffective charge-out of overhead cost on weaker top-line. With a higher effective tax rate of 30.4% (vs. 15.5%), NP dropped 77%. **QoQ**, 1Q19 revenue dropped 4% despite seasonally stronger 1Q19. With low operational efficiency alongside higher raw material costs (+20%), CNP dropped to RM2.6m (-77%) on thinner CNP margin of 3.2% (-10.1ppt).

Prospect to recover in 2H19. Though earnings shortfall was observed in 1Q19 with 2Q19 potentially still sluggish, we believe sales should pick up in the 2H19 once the group's customers have streamlined its operations to navigate through the trade-war barriers. Meanwhile, our check with management suggested that the slowdown is only a temporarily one as the fundamental of the business (increasing semiconductor content on automobile and prevailing of autonomous driving) is still intact. Note that the group is still at an investment phase for customers, though at a slower pace in FY19 (with capex of RM30m-RM50m vis-à-vis a normal threshold of RM80m). Beyond that, capex should normalise as it is on the verge of shifting into "smarter factories", which spells better operational efficiency ahead on higher automation.

Maintain MARKET PERFORM with a lower TP of RM10.20 (from RM18.20). Post model updates, we forecasted CNPs of RM29.1m/RM34.6m (-41%/-21%) after assuming lower utilisations of 68%/75% in FY19 (vs. 80% previously) alongside capex of RM40m/RM80m (vs. RM100m previously) for FY19E/FY20E. All in, our TP is cut to RM10.20, still based on an unchanged 15.0x FY19E PER (which is in line with the Malaysian's OSAT current 2-year Fwd. PER). Maintain MARKET PERFORM as we see limited downside with most negatives having priced in at this level.

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

MARKET PERFORM ↔

Price: RM10.56
Target Price: RM10.20 ↓

Expected Capital Gain: -RM0.36 -3.4%
Expected Divd. Yield: +RM0.14 +1.3%
Expected Total Return: -RM0.22 -2.1%

KLCI Index 1,695.62

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)	454.2
Par value per share (RM)	1.00
52-week range (H)	22.70
52-week range (L)	9.85
Free Float	41%
Beta	1.8
3-mth avg daily vol:	112,272

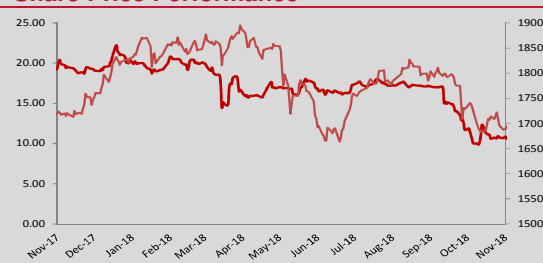
Major Shareholders

Sunright Ltd	48.4%
Kumpulan Wang Persaraan	6.1%
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	32.1	47.3
PBT	43.7	32.3	48.9
Net profit	39.3	29.1	44.1
Core Net Profit	39.3	29.1	44.1
Consensus (NP)	-	47.5	53.4
Earnings Revision	-	-41%	-21%
Core EPS (sen)	91.5	67.7	102.4
Core EPS growth (%)	-10.6	-26.0	51.3
DPS (sen)	18.5	13.7	20.7
BV/Share (RM)	8.2	8.7	9.5
Core PER	11.5	15.6	10.3
PBV (x)	1.3	1.2	1.1
Net. Gearing	-0.3	-0.4	-0.5
Div. Yield (%)	1.8	1.3	2.0

Share Price Performance



	1 mth	3 mths	12 mths
Absolute (%)	-11.1%	-38.6%	-48.2%
Relative (%)	-9.6%	-32.2%	-46.7%

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Results Highlights

	1Q	4Q	QoQ	1Q	YoY	1Q	1Q	YoY
FYE July (RM'm)	FY19	FY18	Chg	FY18	Chg	FY19	FY18	Chg
Revenue	81.6	85.3	-4.3%	90.7	-10.1%	81.6	90.7	-10.1%
EBITDA	23.1	29.7	-22.4%	32.9	-29.9%	23.1	32.9	-29.9%
EBIT	3.5	9.9	-64.6%	13.6	-74.2%	3.5	13.6	-74.2%
PBT	3.8	10.0	-61.9%	13.5	-71.8%	3.8	13.5	-71.8%
Taxation	-1.2	1.3	-186.1%	-2.1	-44.4%	-1.2	-2.1	-44.4%
PAT	2.6	11.3	-76.7%	11.4	-76.8%	2.6	11.4	-76.8%
Net Profit	2.6	11.3	-76.7%	11.4	-76.8%	2.6	11.4	-76.8%
EPS (sen)	0.1	26.3	-99.8%	0.3	-76.9%	0.1	0.3	-76.9%
DPS (sen)	0.0	6.0		0.0		0.0	0.0	
EBITDA margin	28.3%	34.8%		36.3%		28.3%	36.3%	
EBIT margin	4.3%	11.6%		15.0%		4.3%	15.0%	
PBT margin	4.7%	11.7%		14.8%		4.7%	14.8%	
PATAMI margin	3.2%	13.3%		12.5%		3.2%	12.5%	
Effective tax rate	-30.4%	13.4%		-15.5%		-30.4%	-15.5%	

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.			
D&O GREEN TECHNOLOGIES BERHAD	0.860	892.4	Y	12/2018	15.8%	16.7%	111%	28%	46.2	31.1	24.3	4.1	4.1	13.2%	0.9%	1.000	OP
KESM INDUSTRIES BERHAD	10.56	454.2	Y	07/2018	-9.8%	15.1%	-26%	51%	11.5	15.6	10.3	1.3	1.2	7.9%	1.3%	10.20	MP
MALAYSIAN PACIFIC INDUSTRIES BHD	11.68	2323.1	Y	06/2018	8.1%	5.3%	16%	6%	13.6	11.7	11.1	2.0	1.9	13.0%	2.7%	13.00	OP
NOTION VTEC BERHAD	0.710	234.4	Y	09/2018	-12.4%	29.8%	-379%	-142%	19.9	-7.1	17.0	0.7	0.6	-13.6%	0.0%	0.600	UP
P.I.E. INDUSTRIAL BERHAD	1.75	672.1	Y	12/2018	3.6%	19.3%	5%	23%	16.0	15.2	12.3	1.7	1.6	10.5%	3.6%	2.00	OP
SKP RESOURCES BHD	1.23	1537.7	Y	03/2019	5.5%	4.5%	2%	9%	11.9	11.8	10.8	2.7	2.5	20.9%	4.3%	1.45	OP
UNISEM (M) BERHAD	3.23	2363.7	Y	12/2018	-6.3%	9.3%	-35%	34%	14.9	22.9	17.1	1.6	1.6	7.0%	2.8%	3.30	AO

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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