Technology

NEUTRAL ↔

Chip Sales Decline, Cautious Outlook Persists

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We maintain a NEUTRAL stance on the technology sector following the World Semiconductor Trade Statistic (WSTS) downward revision in global semiconductor sales to -10.3% for 2023 (previously -4.1%), coupled with persisting operating challenges faced by players due to underwhelming order recovery. Not helping, companies across our coverage have expanded their capacity and workforce which are now underutilised, contributing to further margin pressure. Smartphone shipments continue to decline while renewed orders for automotive semiconductors remain weak as car manufacturers are still paring down existing inventories. However, certain EMS companies in the industrial products space, such as PIE (OP: TP: RM4.05) and NATGATE (OP; TP: RM1.40) are benefiting from healthy order pipelines. We also like the resilient earnings visibility in KGB (OP; TP: RM1.92) and the growing cybersecurity awareness which benefit the likes of LGMS (OP; TP: RM1.32).

We maintain our **NEUTRAL** call on the technology sector following the underwhelming outlook indicated by players under our coverage. In response to escalating inflation and weakening demand in end-products, particularly those dependent on consumer spending, *WSTS* has further revised its projections of global semiconductor demand downwards in May 2023 to a -10.3% contraction in 2023 (vs. a previous forecast of -4.1%). While the discrete semiconductor and optoelectronics categories are expected to maintain single-digit YoY growth in 2023, with an estimate of 5.6% and 4.6%, respectively, this will likely be entirely offset by other categories which are expected to dip into negative growth territory. This includes memory, which is forecasted to experience a significant decline of 35% YoY.

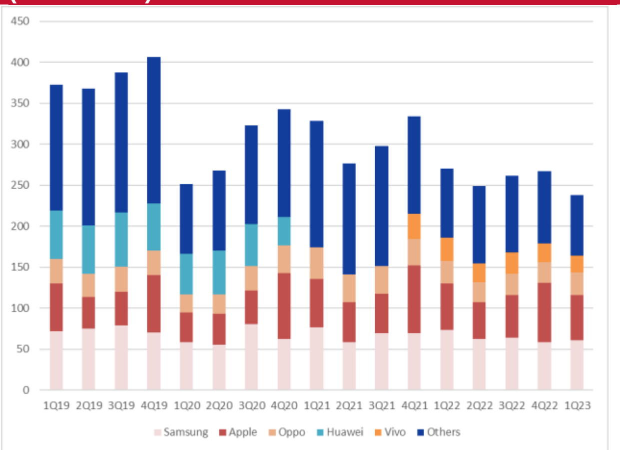
Looking specifically at regional trends for 2023, growth is anticipated in the European and Japanese markets, with projected increases of 6.3% and 1.2%, respectively. On the other hand, a downturn is expected in the remaining regions, with the Americas forecasted to decline by 9.1% and the Asia Pacific region by 15.1%. According to actual global chip sales tracked by the *Semiconductor Industry Association (SIA)*, the demand in 2023 thus far has remained subdued. Despite a modest MoM increase of 0.3% in chip sales in March 2023 (marking the first MoM gain in 10 months since May 2022), it was still a steep decline of 21.3% YoY, resulting in an overall 8.7% YoY decline for 1QCY23. Unfortunately, the latest data indicates that the lacklustre trend has continued in April with chip sales experiencing a substantial 21.3% YoY decrease (see Exhibit 4) across all regions, with China and the Asia Pacific region weighing heavily.

Actual orders continued to diverge from forecasts. Focusing on players under our coverage, we learnt that the 1QCY23 brought a wave of challenges that will likely continue into the subsequent quarters. In addition to the seasonal dip in earnings due to shorter working days during Chinese New Year, companies were faced with disappointing order recovery on an expanded workforce which led to margin pressure. The situation was exacerbated by the recent surge in electricity costs for commercial usage, as well as the lingering effects of the wage hike for foreign workers. In light of these challenges, players are navigating a landscape of elevated operating costs, prompting a cautious approach to rationalise operating cost. This caution stems from the glaring disparity between the optimistic forecasts verbally indicated by customers and the actual orders committed.

Focused on alleviating margin pressure. To combat further erosion of margins, players will prioritise implementing measures aimed at mitigating those challenges. For instance, **MPI (UP; TP: RM15.26)** is bracing itself for yet another quarter of net loss (albeit reduced) and has made the decision to delay the completion of its new plant in China for the second time. The revised timeline now extends the completion date to January 2025, incurring a fine of USD900k. **D&O (UP; TP: RM2.68)**, with a substantial 50% of revenue generated from China, has cautioned about the slower-than-expected recovery in the country, which continues to exert downward pressure on their earnings. Consequently, efforts to streamline their workforce and align it with the prevailing soft outlook will persist. Similarly, **SKPRES (UP; TP: RM0.95)** is nearing the completion of its new c.650k sq ft plant (representing a significant c.50% increase in total floor space) next month but has yet to secure any anchor customer. If unsuccessful, the company may have to implement cost cutting measures by not renewing permits for a portion of its foreign workers which are now underutilised due to order cuts by existing customers. As a result, earnings in the upcoming quarters are expected to remain subdued, with only marginal improvements.

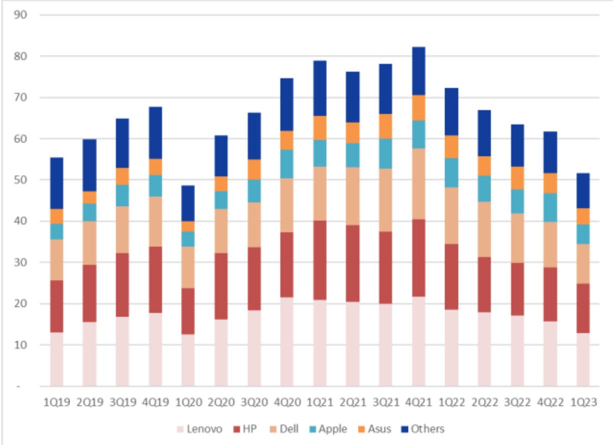
Prospects for smart phone remains dim following the 14.6% YoY decline in 1QCY23 global shipment as published by the *International Data Corporation (IDC)*, which came in worse that the forecasted decline of 12.7% YoY. This marks the seventh consecutive quarter of YoY decline, owing to the underwhelming consumer demand in light of rising inflation and growing macro uncertainties. *IDC* noted that smartphone manufacturers globally have continued to exercise caution, adopting a prudent strategy instead of flooding the channel with excess stock in pursuit of short-term gains. We also maintain our neutral view on **INARI (MP; TP: RM2.46)** given its large exposure (c.60% of group revenue) to the smartphone radio frequency (RF) business. While the company continues to explore new product lines and work on its expansion in China, these efforts may not yield immediate relief to offset the existing weakness.

Exhibit 1: Worldwide Smartphone Sales to End Users (mil of units)



Source: IDC

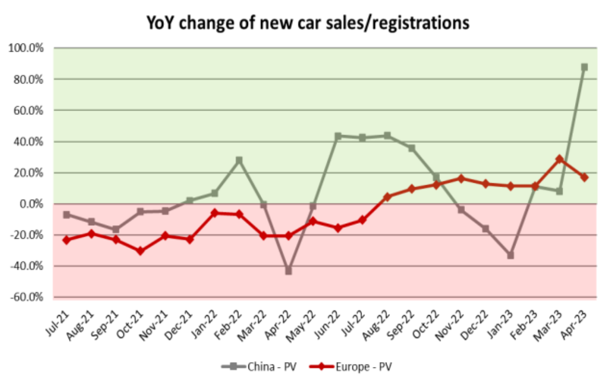
Exhibit 2: Worldwide PC Sales to End Users (mil of units)



Source: Gartner

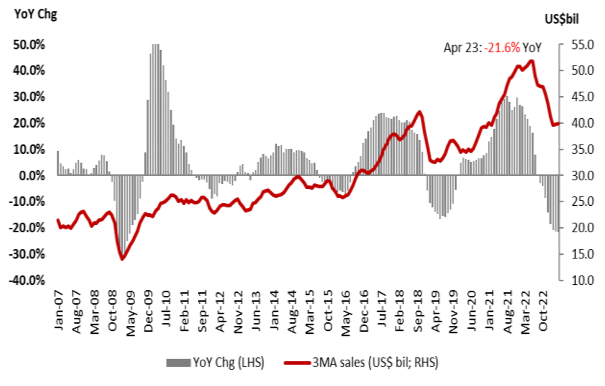
Automotive semiconductors not spared from the slowdown either as consumers become more cautious in their purchases of large-ticket items due to the prevailing high inflation and interest rate environment. Interestingly, there seems to be a discrepancy between car sales data and the earnings reported by automotive semiconductor companies that we cover. The *China Association of Automobile Manufacturers (CAAM)* reported a year-on-year car sales growth of 14.3% in March 2023 and 78.5% in April 2023, while the *European Automobile Manufacturers' Association (ACEA)* recorded car sales growth of 28.8% and 17.2% for the same months. However, upon closer evaluation, these growth figures are based on a very low sales base from the previous year, and a significant portion of the sales was attributed to existing inventories they were trying to reduce. Consequently, the replenishment of new orders remains low, which explains the weak earnings performance of companies like D&O and **JHM (MP; TP: RM0.75)**.

Exhibit 3: Passenger vehicle (PV) sales/registrations growth (% YoY)



Source: CAAM, ACEA

Exhibit 4: Global Semiconductor Sales and YoY growth



Source: SIA

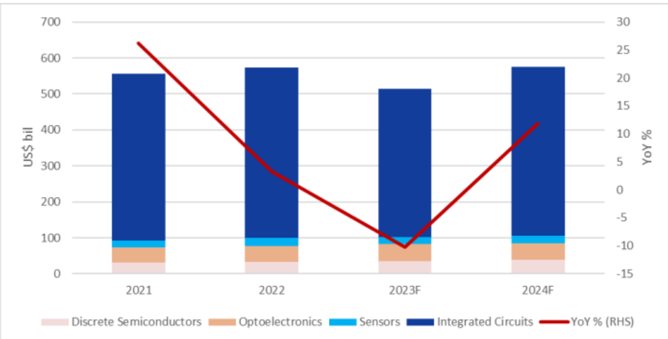
Some hope in the EMS space. Despite the tepid outlook surrounding the technology sector, we still see some upside in certain EMS companies, particularly companies that focus more on industrial products which are seemingly doing better than EMS companies that are solely dependent on consumer electronics. Companies operating in the industrial products space, such as **PIE (OP; TP: RM4.05)** and **NATGATE (OP; TP: RM1.40)**, have been reaping the rewards of increasing demand. In addition to a robust pipeline from existing customers, PIE has also experienced positive developments in its discussion with prospective clients. It has successfully secured two new US-based clients which are involved in medical product and drone equipment. These clients are expected to contribute positively in FY24, with the possibility of commencing pilot production by the end of FY23. On the other hand, NATGATE is currently in discussions with several prospective clients, with 2-3 of them in the final stage of negotiation. These clients, from China and Taiwan are focused on products related to data computing and networking. The group plans to onboard them in 2HFY23, employing a consignment arrangement to minimize the risks associated with component shortages or inventory over-run.

Furthermore, we continue to favour **KGB (OP; TP: RM1.92)** due to its resilient earnings visibility, even amidst the temporary slowdown in the semiconductor industry. This can be attributed to the company's robust RM1.93b order book and promising opportunities from its RM1.4b tender book. For investors seeking exposure to the niche yet thriving cybersecurity sector, **LGMS (OP; TP: RM1.32)** presents a compelling choice. Not only is LGMS expanding its presence in Malaysia, but it is also venturing into emerging digital economies such as Cambodia and Vietnam. These markets are just beginning to recognise the significance of cybersecurity, providing LGMS with significant growth potential. Moreover, LGMS recently formed a strategic partnership with Japan's Mitsui & Co Ltd (Mitsui), which grants the company access to Mitsui's extensive global network, enabling LGMS to enhance its market reach and solidify its position in the cybersecurity domain.

In the medium term, our outlook on the technology sector remains **NEUTRAL** as we anticipate a sustained softening of demand in 3QCY23 with minimal earnings improvements to warrant a sector upgrade. However, we are selectively positive on:

1. **KGB** for: (i) it being a direct proxy to the front-end wafer fab expansion, (ii) its robust earnings visibility underpinned by both robust order book of RM1.93b and tender book of RM1.4b, and (iii) its strong foothold in multiple markets, i.e. Malaysia, Singapore and China.
2. **LGMS** for: (i) its unique exposure to the growing cybersecurity business, (ii) the deep moat around its business given the high barrier to entry created by the tough qualification process as a vendor, and (iii) its new proprietary certification software which is expected to be the next earnings driver.
3. **PIE** for: (i) its comprehensive skillset, making it a one of the top-choice EMS providers for MNCs, (ii) various competitive advantages it enjoys as a unit of Foxconn, and (iii) its diversified and evolving client base, from those involved in communication devices, power tools and the latest decentralised finance (DeFi) equipment.

Exhibit 5: WSTS Semiconductor Sales Forecasts by Product Type (Spring 2023)



Source: WSTS

Malaysian Technology Peers Comparison

Name	Rating	Last Price (RM) @ 23/06/23	Target Price (RM)	Upside (%)	Mkt Cap (RM'm)	Shariah Compliant	Current FYE	Core EPS (sen)		Core EPS Growth		PER (x) – Core Earnings		PBV (x)	ROE (%)	Net. Div. (sen)	Net. Div. Yld (%)
								1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.
D&O GREEN TECHNOLOGIES BHD	UP	3.70	2.68	-27.6%	4,580.1	Y	12/2023	7.8	10.7	-1.0%	37.9%	47.6	34.5	5.0	10.7%	1.3	0.4%
GHL SYSTEMS BHD	OP	0.800	1.05	31.3%	913.2	Y	12/2023	3.0	3.4	21.3%	12.9%	26.7	23.7	1.7	6.5%	0.0	0.0%
INARI AMERTRON BHD	MP	2.64	2.46	-6.8%	9,854.9	Y	06/2023	9.0	10.2	-14.1%	13.1%	29.4	26.0	3.9	13.3%	8.6	3.3%
JHM CONSOLIDATION BHD	MP	0.740	0.750	1.4%	448.4	Y	12/2023	3.5	5.0	-8.3%	43.6%	21.3	14.8	1.3	6.5%	0.5	0.7%
KELINGTON GROUP BHD	OP	1.49	1.92	28.9%	958.1	Y	12/2023	8.7	9.0	1.1%	3.2%	17.1	16.6	3.4	21.3%	2.4	1.6%
KESM INDUSTRIES BHD	MP	7.02	6.91	-1.6%	302.0	Y	07/2023	(15.8)	1.2	-3500.0%	-92.6%	N.A.	566.6	0.9	-1.9%	7.5	1.1%
LGMS BHD	OP	1.07	1.32	23.4%	497.0	Y	12/2023	3.1	5.3	12.7%	70.4%	34.4	20.2	5.0	15.7%	0.0	0.0%
M'SIAN PACIFIC INDUSTRIES	UP	28.20	15.26	-45.9%	5,608.9	Y	06/2023	41.8	105.8	-74.7%	153.3%	67.1	26.6	2.8	4.1%	35.0	1.2%
NATIONGATE HOLDINGS BHD	OP	1.35	1.40	3.7%	2,799.8	Y	12/2023	5.0	6.1	20.4%	22.8%	27.2	22.1	8.6	37.1%	0.3	0.2%
OPPSTAR BHD	MP	1.86	1.82	-2.2%	1,183.3	N	12/2023	4.5	6.1	34.0%	36.3%	41.7	30.6	7.5	19.3%	1.1	0.6%
PIE INDUSTRIAL BHD	OP	2.92	4.05	38.7%	1,121.4	Y	12/2023	22.5	25.3	22.0%	12.5%	13.0	11.5	1.8	14.6%	7.0	2.4%
SKP RESOURCES BHD	UP	1.13	0.950	-15.9%	1,765.5	Y	03/2024	6.3	7.1	-31.6%	12.5%	17.9	15.9	2.0	11.4%	3.2	2.8%
UNISEM (M) BHD	MP	3.07	2.75	-10.4%	4,952.2	Y	12/2023	8.9	13.8	-41.2%	55.7%	19.9	17.9	2.0	5.9%	6.0	2.0%
Simple Average										-27.2%	34.5%	32.0	23.8	3.5	12.7%		1.2%

Source: 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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