

03 July 2024

Technology

OVERWEIGHT

Dawn of a New Upcycle



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We maintain **OVERWEIGHT** on the technology sector. World Semiconductor Trade Statistics (WSTS) recently raised its projection for global semiconductor sales in CY24 to +16% (from +13.1%) driven by strong demand for memory and logic ICs. Following six consecutive months of YoY growth in semiconductor sales (Nov 2023 to Apr 2024), Malaysian players—which are mostly at the back end—are beginning to feel the positive impact. They guided for improving order visibility in coming quarters, which is consistent with our view of a recovery in 2HCY24. Our top picks are: (i) **INARI** (OP; TP: RM4.60) for its growing presence in China's smartphone market and the AI space, (ii) **KGB** (OP; TP: RM4.10) for its strong earnings visibility backed by a RM1.3b order book, and (iii) **LGMS** (OP; TP: RM1.90) on higher demand for cybersecurity services from corporations locally on the heels of the enactment of Cybersecurity Bill 2024.

Recovery gaining momentum. We reiterate **OVERWEIGHT** on the technology sector. Global semiconductor industry data aggregator and forecaster WSTS in Jun 2024 raised its projection for CY24 global semiconductor sales to 16% (from 13.1% it projected in Nov 2023) driven by expectations for stronger YoY recovery from the memory segment (+77% from +45%) and logic ICs (+10.7% from +9.6%). Geographically, WSTS upgraded their sales forecasts for the Americas (+25% from +22%) and Asia Pacific (+18% from +12%). These two regions will lead the recovery in CY24, accounting for c.27% and c.56% of total global sales, respectively.

Global semiconductor sales bottomed out and rebounded in Nov (+5.3%) and Dec (+11.6%) CY23 and had since stayed on a recovery trajectory into 1QCY24 (+15.2% YoY). The YoY growth from Jan to Mar 2024 was consistent in the mid-teens.

We believe the seasonally weak 1QCY24 is behind the sector with its earnings momentum poised to pick up strongly in 2HCY24. We sense optimism among Malaysian players—which are mostly at the back-end—from their tone during their recent post-1QCY24 result briefings as the recovery in the semiconductor sector that started early this year trickles down the value chain.

In the OSAT space, we continue to favour **INARI** as a laggard play. Over the immediate term, it will be buoyed by the upcoming new US smartphone launch featuring AI functionality. We also expect strong sales amidst a new replacement cycle for smartphones (most users last bought a new phone 2-3 years ago during the pandemic). We raise our TP by 15% to RM4.60 (from RM4.00) as we roll forward our valuation base year to CY25F (from FY25F) and upgrade our forward multiple to 35x (from 30x), which is at a 10% premium to the updated peer valuations. The premium is to factor in **INARI**'s strong pricing power as reflected in its net margin being consistently in excess of 20% (vs. in single-digit of its peers).

Meanwhile, its strategy of "China for China; Penang for the West" will reduce its customer concentration risk. Selling predominantly to the West at present, **INARI** will sell to China more significantly via its 54.5%-owned China-based Yiwu Semiconductor International Corporation, which is building a 500k sq ft plant in Yiwu, to be operational by mid-2024. We see tremendous potential in China's smartphone market following Huawei's 7nm processor breakthrough that has re-ignited the interest in China-brand smartphones among consumers in China.

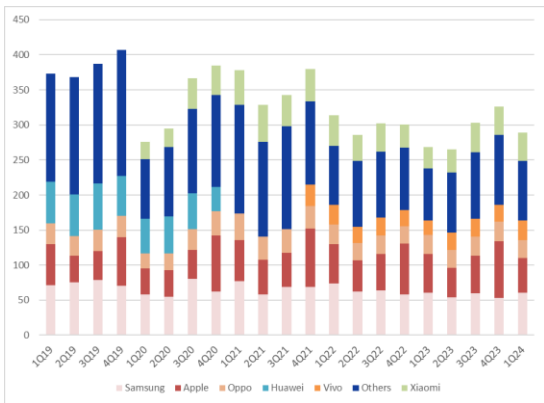
Over the medium to long term, it has plans to supply more significantly to AI-related products. At present, it is producing memory products in small volumes via a single line for a customer, with plans to expand to four lines by June 2024. Given that memory goes hand in hand with graphical processing power, memory products will ride on the growing adoption of AI applications. Similarly, its optical transceivers are also riding on the AI adoption driven by the transition to 800G by customers seeking faster data transfer rates within AI-enabled data centres.

We have also turned positive on **MPI** (OP; TP: RM46.84) on the back of improving utilisation rate at its plant in Suzhou on the recovery in China's smartphone market driven by Huawei's 7nm processor breakthrough and premiumisation by Xiaomi and Honor. Meanwhile, the loading volume at its plant in Ipoh is stable.

We continue to like **KGB** as a key proxy to the front-end wafer fab expansion which is likely to pick up more aggressively in the 2HCY24. The group continues to see a higher proportion of high purity (UHP) gas solution jobs in its pipeline, making up c.78% (vs. 60% in FY23) of its RM1.25b outstanding order book. Meanwhile, its tender book remains elevated at RM1.6b, predominantly for potential jobs from China and Singapore.

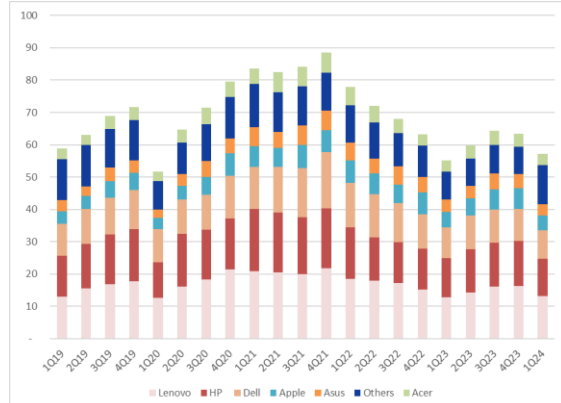
We understand that the demand from China stems from the country’s ambitious goal to increase its semiconductor capacity by 60% in the next three years to cater for local consumption while Singapore’s demand comes from existing MNCs in the area looking to expand their capacity. The group has also set up offices and begun tendering in new regions (i.e. Hong Kong and Germany) at the request of existing semiconductor customers. All in, **KGB** is optimistic to secure at least RM1b order replenishment in 2024 with current job secured standing at RM235m as at 1QCY24.

Exhibit 1: Worldwide Smartphone Sales (m units)



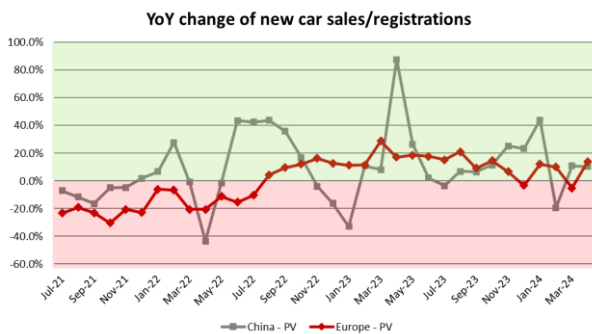
Source: IDC

Exhibit 2: Worldwide PC Sales (m units)



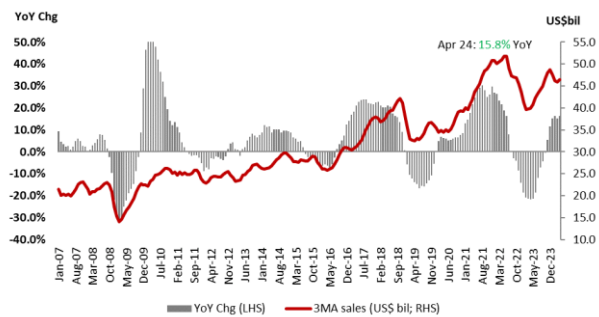
Source: Gartner

Exhibit 3: Sales of Passenger Vehicles (% YoY)



Source: CAAM, ACEA

Exhibit 4: Global Semiconductor Sales (% YoY)



Source: SIA

The worst is over for automotive semiconductor inventory correction. We understand that while the worst is over, automotive semiconductor makers are still navigating the inventory correction that started a few quarters ago. Among the challenges is a soft EV market globally as potential EV buyers are now mostly made up of single-car owners who put a lot of consideration on the range the car can travel on a full charge, vs. mostly multiple-car owners previously. No helping either, is the investment in charging infrastructure that is significantly lagging the growth in EV population, prompting leading EV manufacturer BYD to reconsider plug-in hybrids.

Automotive semiconductor players will have to reassess their customer concentration risk in the EV sector in China and step up their diversification to the European automotive market. More so, the European Commission has imposed an additional tariff of between 17.4% and 38.1% on Chinese EVs, on top of the existing EU duty of 10%. This follows President Biden’s move a month ago to increase tariffs on Chinese EVs from 25% to 100%. We anticipate more supply chain shifts, which could potentially benefit Malaysia, given its neutral stance in the US-China trade conflict. However, unlike consumer devices, the automotive supply chain is rather sticky due to lengthy qualification durations. Hence, this mixed outlook influences our cautious stance on automotive semiconductor companies like **D&O (MP; TP: RM3.60)**, whose valuation remains high, while **JHM (MP; TP: RM0.61)** has yet to see significant progress from its various projects still in the incubation stage. Meanwhile, we continue to monitor a long-forgotten name — **KESM (MP; TP RM7.04)** — an automotive semiconductor burn-in and test service provider which has missed out entirely on the previous tech run (2020-2022) but has strategically invested RM143m (which is c.63% of its FY23’s revenue) to revamp all its equipment in anticipation to capture next-gen automotive chips in the coming upcycle.

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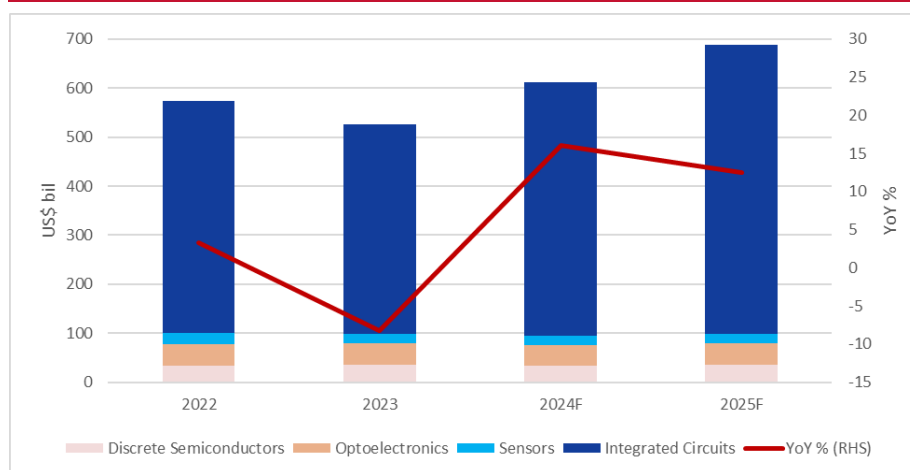
EMS segment gets a shot in the arm from AI-related products. Companies with diversified portfolios and substantial exposure to industrial products have proven to outperform peers that are heavily reliant on consumer electronics as their primary revenue driver. This is true for both **PIE (OP; TP: RM6.75)** and **NATGATE (OP; TP: RM2.06)** which saw share price rallied >100% and >30% YTD, respectively, on the back of securing new customers related to AI data centres. **PIE** secured a Chinese customer (known for server switches) which has committed to occupy PIE's entire new plant 6 (c. 280k sq ft) with mass production to begin by 2025. Meanwhile **NATGATE's** venture into own-brand AI servers (20 units delivered in 1QCY24, another 980 units to go for 2024) continues to remain in the spotlight, riding on the data centre boom in Malaysia. However, we believe that current share prices have well reflected the respective outlook for both these companies, and further upside will likely depend on valuation re-rating rather than earnings upgrades. Meanwhile, we have turned positive on **SKP (OP; TP: RM1.35)** as its value has emerged with improved recovery visibility from an existing customer related to household products. The group is in the process of securing two new potential customers, aiming to begin production towards the end-2024. Note that SKP remains focused on consumer household products and does not benefit from the AI/data centre valuation premium enjoyed by the other EMS companies mentioned above.

Opportunities in cybersecurity in the software segment. **LGMS** is a good proxy to the growing cybersecurity awareness in Malaysia on the heels of the enactments of Cybersecurity Bill 2024. This bill affects both individuals and businesses, particularly those within the Critical National Information Infrastructure (CNII), by mandating compliance with cybersecurity standards. Many cybersecurity incidents in Malaysia have gone unreported due to the lack of disclosure requirements, an issue the bill aims to address. Once the bill is enforced (pending royal assent), company directors may face personal liability for offenses if found negligent in their cybersecurity preparedness. **LGMS** has timely launched its Star Sentry product in anticipation of the upcoming demand wave. This innovative plug-and-play device seamlessly connects to users' networks, autonomously analysing all connected devices for vulnerabilities.

In summary, we reiterate our **OVERWEIGHT** call on the technology sector with the following top picks:

- INARI** for: (i) being the closest proxy to 5G adoption, (ii) being highly responsive to the market demand with the roll-out of new technologies such as double-sided moulding (DSM) and system-on-module (SOM), and (iii) its significant expansion in China, capitalising on the superpower's aggressive push for semiconductor self-sufficiency.
- KGB** for: (i) being a direct proxy to the front-end wafer fab expansion, (ii) its solid earnings visibility underpinned by both robust order book of RM1.3b and tender book of >RM1.9b, and (iii) its strong foothold in multiple markets, i.e. Malaysia, Singapore and China.
- LGMS** for: (i) the high growth prospects of its core cybersecurity business in the under-penetrated local and regional cybersecurity markets, and specifically, higher demand for cybersecurity services from corporations locally on the heels of the enactment of Cybersecurity Bill 2024, (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 Star Sentry product as a new growth driver.

Exhibit 5: WSTS Semiconductor Sales Forecasts*



Spring 2024; Source: WSTS

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Malaysian Technology Peers Comparison

Name	Rating	Last Price (RM) @ 14.06.2024	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	MP	3.94	3.60	-8.6%	4,881.5	Y	12/2024	8.5	12.0	133.7%	41.6%	46.6	32.9	4.9	10.8%	1.4	0.4%
GHL SYSTEMS BHD	AO	1.07	1.08	0.9%	1,221.4	Y	12/2024	2.4	2.8	-3.5%	15.8%	44.8	38.8	2.3	5.2%	0.0	0.0%
INARI AMERTRON BHD	OP	3.83	4.60	20.1%	14,426.4	Y	06/2024	9.4	11.8	8.6%	25.8%	40.7	32.3	5.4	13.4%	8.9	2.3%
JHM CONSOLIDATION BHD	MP	0.680	0.610	-10.3%	409.1	Y	12/2024	3.3	4.1	40.0%	21.7%	20.4	16.7	1.2	6.2%	0.5	0.7%
KELINGTON GROUP BHD	OP	3.62	4.10	13.3%	2,430.2	Y	12/2024	16.1	19.4	1.0%	20.5%	22.4	18.6	5.7	27.7%	4.5	1.2%
KESM INDUSTRIES BHD	MP	7.41	7.04	-5.0%	318.7	Y	07/2024	4.0	8.1	-65.1%	102.8%	184.8	91.2	0.9	0.5%	0.0	0.0%
LGMS BHD	OP	1.55	1.90	22.6%	706.8	Y	12/2024	4.6	6.3	88.4%	37.0%	33.5	24.5	6.8	22.2%	0.9	0.6%
M'SIAN PACIFIC INDUSTRIES	OP	40.00	46.84	17.1%	7,957.2	Y	06/2024	74.5	138.0	141.8%	85.2%	53.7	29.0	3.8	7.2%	35.0	0.9%
NATIONGATE HOLDINGS BHD	OP	1.99	2.06	3.5%	4,127.1	Y	12/2024	6.3	8.3	114.8%	30.8%	31.5	24.1	7.8	27.4%	1.0	0.5%
OPPSTAR BHD	OP	1.49	1.70	14.1%	954.0	Y	12/2024	5.7	6.5	165.0%	15.4%	26.3	22.7	5.4	22.4%	1.4	0.9%
PIE INDUSTRIAL BHD	OP	7.08	6.75	-4.7%	2,719.0	Y	12/2024	22.2	28.7	15.7%	29.3%	31.9	24.7	4.1	13.4%	7.0	1.0%
SKP RESOURCES BHD	OP	1.22	1.35	10.7%	1,906.1	Y	03/2024	7.3	8.5	18.5%	15.3%	16.7	14.4	2.0	12.4%	3.7	3.0%
UNISEM (M) BHD	MP	4.37	3.70	-15.3%	7,049.2	Y	12/2024	10.2	12.7	100.1%	24.9%	43.0	34.4	2.9	6.8%	6.0	1.4%
Simple Average										44.1%	32.8%	37.5	28.2	4.1	13.5%		1.0%

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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