Malaysia

MARKET DATELINE

PP 7767/09/2010(025354)

RHB Research Institute Sdn Bhd
A member of the RHB Banking Group
Company No: 233327 -M

20 November 2009

New Listing

Kelington

Public Issue Of 9.71m New Shares

Offer Price : RM0.53

Fair Value : RM0.85

Table 1: Investment Statistics **Bloomberg: KGRB MK**

FYE Dec	Turnover (RMm)	Pre-tax Profit (RMm)	Net Profit (RMm)	EPS (sen)	EPS Growth (%)	PER (x)	P/NTA (x)	ROE (%)	Gearing (x)	GDY (%)
2008	60.1	7.1	6.6	8.8	62.4	9.7	4.8	50.1	Net cash	-
2009f	63.1	7.9	6.8	9.2	3.6	9.3	4.0	34.6	Net cash	-
2010f	75.4	9.5	8.3	11.1	21.0	7.7	3.1	31.1	Net cash	-
2011f	89.6	11.2	9.8	13.2	18.8	6.5	3.1	28.2	Net cash	-
2012f	108.1	13.2	11.6	15.5	17.9	5.5	0.0	25.9	Net cash	-

Valuations based on estimated fair value of RM0.85/share

Issued capital (m shares) 74.7 (RM0.10 par) **Market capitalisation (RMm)** 63.5

- **Background.** Kelington is primarily involved in the provision of Ultra High Purity (UHP) gas and chemical delivery solutions for the wafer fabrication, flat panel display (FPD), solar energy and storage media industries. Kelington has 18.4% share of the market in 2008 (vs. 75% for Linde Group).

- **Operating landscape.** We understand that the players in the UHP delivery system market consist of three categories (see Table 2). While major gas and chemical providers have the necessary resources and global reach to compete for large-scale projects, they tend to outsource the UHP delivery system solution to specialised engineering companies (i.e. Kelington) as this would allow them to focus on their core competency (i.e. supply of gas and chemicals).

- **Sector prospects.** We believe Kelington is poised to benefit from the higher capex spending by major foundries. Already, TSMC (world's largest wafer foundry) and UMC have raised their 2009 capex to US$2.3bn and US$500m (from US$1.5bn and US$400m previously) to ramp up their 40-nm wafer fabrication process amidst stronger-than-expected chips demand from China. According to Frost & Sullivan, the UHP delivery system market in China and Taiwan are expected to register FY08-13 CAGR of 13% and 10% respectively.

- **Risks.** 1) Competition from smallish players moving up the value chain; 2) Lack of long-term contracts; 3) Fluctuating raw material prices; and 4) Dependence on two key customers.

- **Forecasts.** Based on secured contracts and assuming a 30% success rate with new bids, we have projected FY09 net profit of RM6.8m, and thereafter to grow by 21% for FY10, 19% for FY11 and 18% for FY12. We have assumed FY09-12 EBITDA margins to remain stable at around 13-14% p.a. (vs. 12.5% in FY08) due to stronger contribution from higher-margin hook-up systems arising from foundries expansion and advancement in manufacturing technology.

- **Valuations.** We have assumed FY10 PER target of 11x for technology stocks under our coverage. Although Kelington has strong earnings growth (i.e. FY08-12 EPS CAGR of 15.1%), we note potential earnings risk due to the competitive environment and lack of long-term contracts. For Kelington, based on our FY10 earnings estimate, and applying 7.7x FY10 PER i.e. 30% discount to the sector, suggests a fair value of RM0.85/share or 60.4% upside from the IPO price of RM0.53.

LISTING DETAILS

Listing Sought : Bursa Malaysia ACE Market

Listing Date : 25 Nov 2009

Public Issue : 9.71m shares including:
-0.96m to public
-2.81m to employees
-5.94m private placement

MAJOR SHAREHOLDERS

Palace Star..............................53.2%
Sky Walker..............................12.9%

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Please read important disclosures at the end of this report.

BUSINESS BACKGROUND

- **Background.** Kelington is primarily involved in the provision of Ultra High Purity (UHP) gas and chemical delivery solutions for the wafer fabrication, flat panel display (FPD), solar energy and storage media industries. Headquartered in Shah Alam, the company has also established presence in Singapore, China and Taiwan. Kelington has 18.4% share of market in 2008 (vs. 75% for Linde Group).

- **Products & services.** Kelington provides turnkey solutions ranging from designing, fabrication, installation, maintenance and servicing. The company derives its income from three main segments:
  1) **Base build.** The base build represents the 'back bone' of the entire UHP delivery system, which connects the gas and chemical source to be distributed throughout the foundry or manufacturing plant. Note that every foundry or high-technology manufacturing plant will have one base build and is usually constructed together with the new plant.
  2) **Hook-up.** It is basically the last-mile delivery system i.e. from base build to primary and process tools. Unlike base build, a foundry typically has three to four hook-up systems installed on the same base build.
  3) **Maintenance services.** The company provides maintenance services for the UHP delivery system, which is done via maintenance contracts or ad-hoc basis (i.e. break-down of the system).

- **Competitive landscape but….** We understand that the players in the UHP delivery system market consist of three categories (see Table 2). While major gas and chemical providers have the necessary resources and global reach to compete for large-scale projects, they tend to outsource the UHP delivery system solution to specialised engineering companies (i.e. Kelington) as this would allow them to focus on their core competency (i.e. supply of gas and chemicals).

Table 2: Three Main Categories In The UHP Delivery System Industry

Category	Companies	Competency
Gas and chemical providers	Air Liquide, Air Products, Linde Group, Messer Group, Praxair, Super Clean Technology Co	Total UHP gas/chemical delivery system solution including gas/chemical supply
UHP delivery system engineering companies	Kelington Group, Marketech International Corp, Wholetech System Hitech Limited, Kinetics Process Systems	Total UHP gas/chemical delivery system solution excluding gas/chemical supply
UHP delivery system installation companies	Highly fragmented with 50-70 companies that act as installers of UHP systems	Only installation and building works for the UHP delivery system.

Source: RHBRI

- **Competitive advantage.** Although Kelington operates in a highly fragmented market, we believe the company stands out among its peers given the following reasons:
  1) **Proven track record.** We understand that providers' strong track record is crucial in securing contracts given that UHP delivery systems mainly involve hazardous gases and chemicals which are flammable, toxic or corrosive. Given the cost of the UHP delivery system being relatively insignificant when compared to the cost of the wafer fab itself, customers are willing to pay higher for more reliable systems developed by established suppliers. We note that the company has successfully executed major projects in Malaysia (i.e. SilTerra), Taiwan (Hannstar Display), Singapore (Renewable Energy Corp) and China (TSMC).
  2) **Strong partnership with reputable gas and chemical providers.** In strengthening its position as a leading UHP delivery solutions provider, Kelington is partnering major gas and chemical producers to undertake UHP projects, i.e. Air Liquide, Air Products and Linde Group (three of the four world's largest gas and chemical providers). We understand that major contracts are awarded out to these producers, which in turn subcontract out to specialised engineering companies (i.e. Kelington) for the design, build and commissioning of the UHP delivery system.

BUSINESS OUTLOOK

- **Higher capex spending by major foundries.** We believe Kelington is poised to benefit from the higher capex spending by major foundries. Already, TSMC (world's largest wafer foundry) and UMC have raised their 2009 capex to US$2.3bn and US$500m (from US$1.5bn and US$400m previously) to ramp up their 40-nm wafer fabrication process amidst stronger-than-expected chips demand from China. According to Frost & Sullivan, UHP delivery system market in China and Taiwan are expected to register FY08-13 CAGR of 13% and 10% respectively. Note that equipment orders continue to gain traction with Sep orders increased to US$732m, as compared to US$599m in Aug 09 and its 18-year low of US$246m in Mar 09. In tandem, North

America-based manufacturers of semiconductor book-to-bill ratio in Sep 09 was 1.17x, which compares to a low of 0.47x in Jan 09 and 1.06x in Aug 09.

- **FY09-12 revenue CAGR of 21%.** We note that Kelington registered FY06-08 revenue CAGR of 41%, mainly driven by base build projects in Malaysia. Going forward, we estimate FY09-12 revenue CAGR of 20%, which will be driven mainly by: 1) higher contribution from overseas projects (arising from higher capex spending for major foundries such as TSMC and UMC); 2) penetration into new industry i.e. solar energy, LED and bioscience; and 3) stronger contribution from higher-margin hook-up jobs stemming from plant expansion and technological advancement in the manufacturing processes (i.e. miniaturisation of line widths in wafer fabrication as well as increasing size of glass substrates in flat panel display).

- **Orderbook and tenders.** Kelington currently has an outstanding orderbook of around RM75m, which would last until end-2010. We note that 34% of the current orderbook is from wafer fab industry, with the balance from solar energy (25%), flat panel display (11%), storage media (3%) and others. The company has tendered for around RM60-70m worth of new contracts. Management highlighted that the company has won 30-40% of the total contracts that it has tendered for since 2000.

- **Risks.** We believe the company faces a number of risks, including:

1) **Competition –** Although there are only three established engineering companies (i.e. Marketech International Corp, Wholetech System Hitech Limited and Kinetics Process Systems) competing head-on with Kelington in the UHP delivery system market currently, we highlight that other smallish players (i.e. UHP systems installers) could potentially move up the value chain (via acquiring the technology know-how) and become one-stop UHP delivery system providers.

2) **Lack of long term contracts.** It is an industry norm that users of gas and chemical delivery equipment do not enter into long-term contracts with suppliers. Hence, we believe Kelington's earnings outlook is closely tied to the cyclical nature of foundries' capex spending.

3) **Fluctuating raw material prices.** Kelington is also affected by the fluctuation in raw material prices as cost of steel piping and fittings account for about 50% of its project cost. We estimate that a 10% appreciation of the steel prices would reduce Kelington's earnings by 3%.

4) **Dependence on customers**. Kelington's revenue is mostly derived from BOCLH group of companies (i.e. CTC, BOC Lienhwa and BOCLH Industrial Gases) and Pembinaan Ando (see Table 5). Note that BOCLH is a jv between Lien Hwa Industrial Corp of Taiwan and BOC Group of United Kingdom. BOCLH is also a related company of Kelington by virtue of their indirect shareholding interest in Kelington through Sky Walker. If any of the above customers discontinue the service from Kelington, the company may lose significant market share and consequently lower the Group's earnings, in our opinion.

Table 3. Major customers for FY08

	% of Total Sales FY08
BOCLH Group of companies (i.e. CTC, BOC Lienhwa and BOCLH Industrial Gases)	34.4
Pembinaan Ando	23.5

Source: IPO Prospectus

- **Utilisation of proceeds.** The gross proceeds from the public issue will be used mainly for working capital needs. According to management, the listing is not about raising funds but rather to raise its profile as a leading UHP delivery solutions provider, which will enhance its chances of securing contracts from overseas customers (i.e. China and Taiwan).

Table 4. Utilisation Of Proceeds From The Public Issue

	RMm
Working Capital	2.64
Defray estimated listing expenses	1.76
Capital Expenditure	0.50
R&D expenses	0.25
Total	**5.15**

Source: IPO Prospectus

FORECASTS AND VALUATIONS

- **Forecasts.** Based on secured contracts and assuming a 30% success rate with new bids, we have projected FY09 net profit of RM6.8m, and thereafter to grow by 21% for FY10, 19% for FY11 and 18% for FY12. We have assumed FY09-12 EBITDA margins to remain stable at around 13-14% p.a. (vs. 12.5% in FY08) due to stronger contribution from higher-margin hook-up systems arising from foundries expansion and advancement in manufacturing technology. Upon listing, Kelington will have net cash of RM24.6m.
- **Valuations.** We have assumed FY10 PER target of 11x for technology stocks under our coverage. Although Kelington has strong earnings growth (i.e. FY08-12 EPS CAGR of 15.1%), we note potential earnings risk due to the competitive environment and lack of long-term contracts. By giving a 30% discount to reflect its smaller market capitalisation, we derive a target PER of 7.7x. Accordingly, we derive a fair value of RM0.85/share based on FY10 target PER of 7.7x. There is more upside in FY10-11 if the company wins more contracts (especially lumpy base build projects) on the back of wafer foundries capacity expansion as well as penetration into new industries (i.e. solar energy, LED and bioscience).

Table 5. Peers Historical Valuation

		FY08		
Company	**Bloomberg ticker**	**Market Cap (US$)**	**Net Profit (US$)**	**PER (x)**
Marketech	6196 TT	79.4	6.5	12.2
Hanyang Engineering	045100 KS	79.0	4.7	16.8
Wholetech System Hitech	3402 TT	34.5	0.1	345

Source: RHBRI, Bloomberg

Table 6. Earnings Forecasts

FYE Dec (RMm)	**2008**	**2009f**	**2010f**	**2011f**	**2012f**
Base Build	49.0	51.5	61.8	74.1	89.7
Hook Up	7.9	8.2	9.6	11.1	13.6
Others	3.1	3.4	4.0	4.4	4.8
Revenue	60.1	63.1	75.4	89.6	108.1
Growth (%)	*4.9*	*5.0*	*19.5*	*18.8*	*20.7*
Gross Profit	**12.4**	**12.9**	**15.5**	**18.4**	**22.2**
Gross margin (%)	*20.6*	*20.5*	*20.5*	*20.5*	*20.5*
EBITDA	**7.5**	**8.5**	**10.1**	**12.0**	**14.2**
EBITDA margins (%)	*12.5*	*13.5*	*13.5*	*13.4*	*13.1*
Depreciation	(0.6)	(0.7)	(0.7)	(0.8)	(0.9)
EBIT	7.0	7.9	9.4	11.2	13.3
Interest expense	(0.1)	(0.1)	(0.1)	(0.2)	(0.3)
Interest income	0.2	0.2	0.2	0.2	0.2
PBT	**7.1**	**7.9**	**9.5**	**11.2**	**13.2**
Tax	(0.5)	(1.1)	(1.2)	(1.4)	(1.6)
Effective tax rate (%)	*6.4*	*13.8*	*12.7*	*12.5*	*12.1*
Net profit	**6.6**	**6.8**	**8.3**	**9.8**	**11.6**

Source: Company data, RHBRI's estimates and forecasts

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Stock Ratings

Outperform = The stock return is expected to exceed the FBM KLCI benchmark by greater than five percentage points over the next 6-12 months.

Trading Buy = Short-term positive development on the stock that could lead to a re-rating in the share price and translate into an absolute return of 15% or more over a period of three months, but fundamentals are not strong enough to warrant an Outperform call. It is generally for investors who are willing to take on higher risks.

Market Perform = The stock return is expected to be in line with the FBM KLCI benchmark (+/- five percentage points) over the next 6-12 months.

Underperform = The stock return is expected to underperform the FBM KLCI benchmark by more than five percentage points over the next 6-12 months.

Industry/Sector Ratings

Overweight = Industry expected to outperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Neutral = Industry expected to perform in line with the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

Underweight = Industry expected to underperform the FBM KLCI benchmark, weighted by market capitalisation, over the next 6-12 months.

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20 November 2009

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