

13 August 2020

Construction & Engineering | Industrial

Kelington Group (KGRB MK)

Neutral (Maintained)

A Circuit Breaking Quarter

Target Price (Return): MYR1.14 (+5%)
 Price: MYR1.09
 Market Cap: USD83.5m
 Avg Daily Turnover (MYR/USD): 2.15m/0.50m

- **Stay NEUTRAL with new DCF-derived MYR1.14 TP from MYR1.01 (WACC: 8.8% from 10.5%), 5% upside.** Positive developments in China's semiconductor industry are supportive of stock sentiment. Our TP implies 20x FY21F P/E (+1SD from its 1-year forward rolling 5-year mean). We think this is fair, given that Kelington is an indirect proxy to the semiconductor industry's overall health, as well as our expectations of an earnings rebound in FY21F. Investors should accumulate the stock on weakness to capitalise on the expected strong earnings recovery in FY21.
- **A washout 2Q20 is anticipated.** We expect KGB to remain marginally profitable in 2Q20 (results are slated for announcement on 25 Aug), with core earnings set to decline by a sharp 90-95% YoY (88-94% drop QoQ) to <MYR0.5m – its worst quarterly showing since FY17. Recall that while production has normalised in China, the extended Movement Control Order (MCO) and Circuit Breaker in Malaysia and Singapore shuttered ongoing jobs, with idle costs being recognised.
- **Encouraging developments in China's semiconductor space,** boosted by the [introduction of new state tax incentives](#). This comes on the back of waning technology relations between the US and China. Recently, Semiconductor Manufacturing International Corp (SMIC) (981 HK, NR) announced plans to build a USD7.6bn foundry in Beijing, focusing on the 28nm process and more advanced nodes. We believe KGB is in the right position to capitalise on the said expansion plan, given its status as SMIC's resident contractor with a solid track record in the latter's China operations. As at April, outstanding works from SMIC stand at MYR91m.
- **Higher MYR1.14 TP.** We cut our FY20F earnings by 32%, but raise FY21F earnings by 5%. We also update our WACC assumption with a lower cost of debt and Beta, as per Bloomberg. We think this is fair, given that the low interest rate environment is expected to persist. However, the overall risk profile of the stock has improved, supported by the venture into the industrial gas business or IGB, which offers longer-term recurring earnings.
- **Key downside risks** include slower-than-expected orders, margins weakness, potential revival and/or extension of lockdowns, and execution. Upside risks include contract replenishment exceeding expectations, faster-than-expected recovery in demand for liquid carbon dioxide (LCO2), and COVID-19 subsiding.

Analysts

Jeffrey Tan
 +603 9280 8863
jeffrey.tan@rhbgroup.com

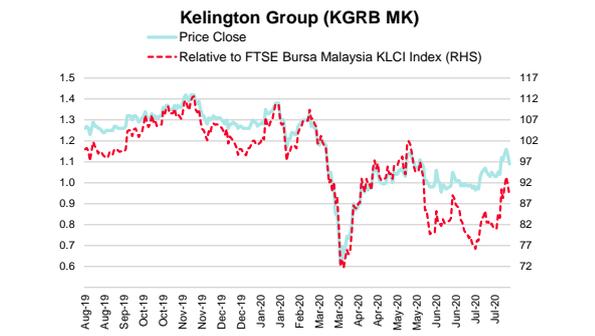


Eddy Do Wey Qing
 +603 9280 8856
wey.qing.do@rhbgroup.com



Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(13.5)	11.8	1.9	(14.2)	(14.2)
Relative	(11.5)	14.0	(10.9)	(15.1)	(10.6)
52-wk Price low/high (MYR)				0.62	1.42



Source: Bloomberg

Forecasts and Valuation	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Total turnover (MYRm)	350	380	342	389	390
Recurring net profit (MYRm)	19	24	10	18	21
Recurring net profit growth (%)	34.1	21.2	(58.9)	84.0	15.9
Recurring P/E (x)	17.39	14.35	34.90	18.97	16.37
P/B (x)	2.9	2.2	2.1	1.9	1.8
P/CF (x)	40.38	17.16	10.14	21.05	14.51
Dividend Yield (%)	0.9	1.7	0.7	1.3	1.5
EV/EBITDA (x)	10.08	7.90	15.11	9.08	7.64
Return on average equity (%)	19.2	18.0	6.1	10.5	11.3
Net debt to equity (%)	net cash				

Source: Company data, RHB

Note:

Small cap stocks are defined as companies with a market capitalisation of less than USD1bn.

Financial Exhibits

Asia	Financial summary (MYR)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Malaysia	Recurring EPS	0.06	0.08	0.03	0.06	0.07
Construction & Engineering	DPS	0.01	0.02	0.01	0.01	0.02
Kelington Group	BV/PS	0.37	0.50	0.52	0.57	0.62
KGRB MK	Return on average equity (%)	19.2	18.0	6.1	10.5	11.3
Neutral						
	Valuation metrics	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Valuation basis	Recurring P/E (x)	18.03	14.88	36.18	19.67	16.97
DCF methodology (WACC : 8.8%, TG: 1.5%)	P/B (x)	3.0	2.3	2.2	2.0	1.8
	FCF Yield (%)	(0.6)	(3.9)	8.1	1.7	3.8
Key drivers	Dividend Yield (%)	0.9	1.6	0.7	1.3	1.5
i. Stellar growth of the semiconductor industry in China;	EV/EBITDA (x)	10.51	8.23	15.83	9.53	8.02
ii. Growing outstanding orderbook;	EV/EBIT (x)	11.34	8.87	19.49	10.87	9.11
iii. New LCO2 business.						
Key risks	Income statement (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
Key downside risks are a slower-than-expected orderbook replenishment rate, margins weakness, and management execution. Upside risks include contract replenishment exceeding expectations, faster-than-expected recovery in LCO2 demand, and COVID-19 subsiding.	Total turnover	350	380	342	389	390
	Gross profit	59	64	49	59	63
	EBITDA	29	37	17	28	32
	Depreciation and amortisation	(2)	(3)	(3)	(3)	(4)
	Operating profit	27	34	14	25	28
	Net interest	(1)	(1)	(2)	(2)	(2)
	Pre-tax profit	25	32	12	23	27
	Taxation	(7)	(8)	(3)	(5)	(6)
	Reported net profit	19	24	10	18	21
	Recurring net profit	19	24	10	18	21
Company Profile	Balance sheet (MYRm)	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
KGB is involved in ultra-high purity (UHP) delivery systems, process engineering and general contracting. The company commenced its maiden production of LCO2 in 4Q19	Total cash and equivalents	67	85	113	117	126
	Tangible fixed assets	25	53	55	61	67
	Total assets	243	303	324	346	361
	Short-term debt	16	12	12	12	12
	Total long-term debt	2	23	23	23	23
	Total liabilities	127	148	162	170	171
	Total equity	116	156	162	175	190
	Total liabilities & equity	243	303	324	346	361
	Key metrics	Dec-18	Dec-19	Dec-20F	Dec-21F	Dec-22F
	Revenue growth (%)	11.7	8.5	(10.0)	13.8	0.2
	Recurrent EPS growth (%)	34.1	21.2	(58.9)	84.0	15.9
	Gross margin (%)	16.7	16.7	14.4	15.2	16.2
	Operating EBITDA margin (%)	8.2	9.6	5.0	7.2	8.3
	Net profit margin (%)	5.3	6.4	2.8	4.6	5.3
	Dividend payout ratio (%)	14.2	22.9	25.0	25.0	25.0
	Capex/sales (%)	3.0	8.8	1.5	2.6	2.6
	Interest cover (x)	29.0	25.9	7.4	13.2	15.1

Source: Company data, RHB

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The industrial gas plant's utilisation rate reached 35% in July from approximately 25% in June. Despite that, we see limited room for the utilisation rate to recover to the pre-MCO level (50%) in the near term, given weaker export demand for LCO2 from Singapore.

The latest check with management suggests that the *halal* certification could be secured in 4Q20, hence delaying the anticipated boost in uptake to 2H21, given that the audit process should take another six months. As such, we lower our average take-up rate for FY20F-21F to 30% and 50% from 37% and 60%.

Outstanding orderbook likely to expand. The strict SOPs in place for some of KGB's key markets – in the form of workforce limitations – are expected to contribute to project execution delays beyond the typical 6-9 months. Consequently, we expect revenue recognition to be deferred to FY21.

While operations in China and Malaysia have recovered close to pre-MCO levels, Singapore is currently at 30% capacity due to manpower mobilisation issues there.

Figure 1: KGB's DCF valuation

7.5	FY21F	FY22F	FY23F	FY24F	FY25F	FY26F	FY27F	FY28F	FY29F	FY30F
EBIT	24.7	28.4	31.8	33.5	39.1	40.4	41.5	39.8	40.7	41.7
EBIT*(1-tax rate)	18.8	21.6	24.2	25.5	29.7	30.7	31.5	30.2	30.9	31.7
Add: D&A	3.5	3.9	4.2	4.6	4.9	5.2	5.5	5.7	6.0	6.2
Less: WC investments (WC Inv)	-4.7	-0.7	-4.2	-2.8	-2.6	-1.8	-1.5	-1.2	-1.4	-1.4
Less: Fixed investments (FC Inv)	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10
FCFF	7.49	14.73	14.22	17.26	22.04	24.08	25.47	24.75	25.49	26.43
Disc. FCFF	6.83	12.25	10.78	11.93	13.90	13.85	13.35	11.83	11.11	10.51
Terminal value at T=10	365.41									
PV of terminal value	156.62									
NPV	116.35									
Enterprise value of firm	272.96									
Add net cash	81.64									
Equity value of firm	354.61									
Equity value per share (MYR)	1.14									
Implied CY21F P/E (x)	20									
				TG	6.8%	7.8%	8.8%	9.8%	10.8%	
				0.5%	1.33	1.18	1.07	0.99	0.93	
				1.0%	1.39	1.22	1.10	1.01	0.94	
Rf	2.9%			1.5%	1.47	1.27	1.14	1.04	0.96	
Beta (x)	1.3			2.0%	1.56	1.33	1.18	1.07	0.98	
Risk premium	6.51%			2.5%	1.67	1.40	1.22	1.10	1.01	
Rm	9.4%									
TG (%)	1.5%									
CoE	11.2%									
CoD	2.4%									
Tax rate	24.0%									
WACC	8.8%									

Source: Company data, RHB

Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2020-06-05	Neutral	1.01	0.98
2020-05-19	Neutral	1.16	1.14
2020-03-13	Buy	1.32	0.97
2020-02-27	Buy	1.43	1.26
2020-02-09	Buy	1.45	1.24
2019-11-20	Buy	1.55	1.35
2019-09-20	Buy	1.58	1.32
2019-08-23	Buy	1.63	1.26
2019-02-27	Buy	1.52	1.24
2019-01-25	Buy	1.41	1.20
2018-07-19	Buy	1.06	0.77

Source: RHB, Bloomberg

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KUALA LUMPUR

RHB Investment Bank Bhd
Level 3A, Tower One, RHB Centre
Jalan Tun Razak
Kuala Lumpur 50400
Malaysia
Tel : +603 9280 8888
Fax : +603 9200 2216

JAKARTA

PT RHB Sekuritas Indonesia
Revenue Tower, 11th Floor, District 8 - SCBD
Jl. Jendral Sudirman Kav 52-53
Jakarta 12190
Indonesia
Tel : +6221 509 39 888
Fax : +6221 509 39 777

BANGKOK

RHB Securities (Thailand) PCL
10th Floor, Sathorn Square Office Tower
98, North Sathorn Road, Silom
Bangrak, Bangkok 10500
Thailand
Tel: +66 2088 9999
Fax :+66 2088 9799

SINGAPORE

RHB Securities Singapore Pte Ltd.
10 Collyer Quay
#09-08 Ocean Financial Centre
Singapore 049315
Tel : +65 6533 1818
Fax : +65 6532 6211