9 November 2018

Construction & Engineering | Industrial

Kelington Group

In a Class Of Its Own; Initiate With BUY

Buy

Target Price:	MYR1.41
Price:	MYR1.21
Market Cap:	USD75.3m
Bloomberg Ticker:	KGRB MK

Initiate coverage with BUY and TP of MYR1.41, 17% upside. KGB's unique exposure to China remains underappreciated, in our view. We believe the US-China trade war will only strengthen China's resolve to achieve technological independence. This should benefit KGB directly, as it is involved in the building blocks of the semiconductor value chain. Earnings will see a leg up from the new industrial gas business in 2019, with KGB dislodging Linde Malaysia's dominant position in the supply and distribution of liquid CO_2.

Unique China play. We expect KGB's exposure to China via its ultra-high purity (UHP) gases and process engineering (PE) segments to catalyse strong earnings expansion over the next few years. This is on the back of China's "Made in China 2025" policy, an industrial blueprint crafted to reduce its reliance on semiconductor imports and attain technological independence by 2025. The US-China trade war should strengthen China's resolve for self-sufficiency, in our view, with an acceleration of key projects in the semiconductor space. This should augur well for KGB where China contributed c.50% of 1H18's revenue.

Growing orderbook of MYR376m as at Oct 2018. KGB has a strong track record for orderbook replenishment, with a CAGR of 18% for new jobs secured during 2014-2017. YTD (Oct), new contracts secured reached a new high of MYR360m or some 96% of total orders secured in 2017 (MYR374m). About 60% of its outstanding orderbook comprises jobs related to the UHP segment, followed by the PE (27%) and general contracting (GC) (13%) segments. The rapid orderbook growth is testament to KGB's strong technical capabilities and execution track record, with notable projects clinched in China and Singapore for major chip foundries. We expect contract/project flows from China to remain strong over the next 6-12 months, given the many semiconductor projects planned by the Chinese Government.

Liquid CO_2 business will provide a new leg of growth. KGB inked a 15-years contract with Petronas for the purchase of CO_2 waste gas in 2017. It is building a 50,000 MT capacity plant in Kerteh at a cost of MYR50-60m, for the purification and processing of waste CO_2, which is due for completion by mid-2019. Upon commencement of operations at the plant, KGB would dislodge the dominant position held by Linde Malaysia for the supply of industrial gases locally. We expect the higher-margin industrial gas business (IGB) to drive a new leg up in earnings via more on-site supply contracts, and the distribution of liquid CO_2 to both the local and export markets over the medium to longer term.

Initiate with BUY and TP of MYR1.41. We ascribed a target P/E of 17x on our 2019F core FD EPS to value KGB – this takes into account the recently-completed share placement exercise of 22.9m shares, and is consistent with the average P/E for local semiconductor/technology peers of 17.2x. In our view, the stock deserves a scarcity premium due to the lack of comparables domestically, and its unique business model that offers growth as well as long-term recurring revenues, supported by a PEG of 0.71x. Our TP is backed by our corroborative DCF valuation of MYR1.43.

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (MYRm)	343	317	367	450	522
Reported net profit (MYRm)	9	12	19	24	29
Recurring net profit (MYRm)	20	16	19	24	29
Recurring net profit growth (%)	232.0	(21.2)	21.2	25.8	22.9
Recurring EPS (MYR)	0.09	0.07	0.06	0.08	0.10
DPS (MYR)	0.01	0.02	0.02	0.02	0.02
Recurring P/E (x)	13.6	17.7	19.6	15.6	12.7
P/B (x)	5.6	4.7	2.7	2.4	2.1
P/CF (x)	27.6	16.0	11.6	14.9	12.2
Dividend Yield (%)	0.8	1.3	1.3	1.6	2.0
EV/EBITDA (x)	29.9	18.0	11.0	8.2	6.3
Return on average equity (%)	6.5	5.1	6.2	7.7	9.5
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash
Our vs consensus EPS (adjusted) (%)			18.4	20.0	23.1

Source: Company data, RHB

Share Data

Avg Daily Turnover (MYR/USD)	3.82m/0.92m
52-wk Price low/high (MYR)	0.6 - 1.28
Free Float (%)	47
Shares outstanding (m)	259
Estimated Return	17%

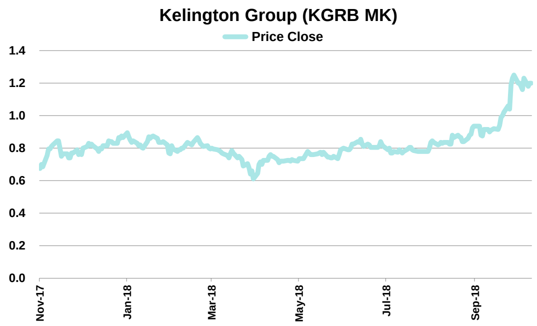
Shareholders (%)

Palace Star	36.1
Sun Lead International	7.7
Credit Suisse	1.7

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	45.8	0.8	44.9	64.6	79.3
Relative	50.0	3.9	49.5	71.4	80.6

Source: Bloomberg



Source: Bloomberg

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Financial Exhibits

Financial model updated on: 2018-11-08

Asia
Malaysia
Construction & Engineering
Kelington
Bloomberg KGRB MK
Buy

Valuation basis

P/E and DCF methodology

Key drivers

i. Strong growth in China's semiconductor industry;
ii. Growing orderbook;
iii. New industrial gas business and on-site gas supply.

Key risks

i. Potential delays in the commencement of its liquid CO_2 plant in Kerteh;
ii. Slowdown in China's semiconductor industry.

Company Profile

Kelington is primarily engaged in the provision of ultra-high purity (UHP) gas delivery systems, the processing of industrial gases, and the provision of process engineering and general contracting services.

Financial summary	**Dec-16**	**Dec-17**	**Dec-18F**	**Dec-19F**	**Dec-20F**
Recurring EPS (MYR)	0.06	0.05	0.06	0.08	0.10
EPS (MYR)	0.03	0.04	0.06	0.08	0.10
DPS (MYR)	0.01	0.02	0.02	0.02	0.02
BVPS (MYR)	0.22	0.26	0.45	0.51	0.58
Weighted avg adjusted shares (m)	306	306	306	306	306

Valuation metrics	**Dec-16**	**Dec-17**	**Dec-18F**	**Dec-19F**	**Dec-20F**
Recurring P/E (x)	18.8	23.8	19.6	15.6	12.7
P/E (x)	41.8	31.4	19.6	15.6	12.7
P/B (x)	5.6	4.7	2.7	2.4	2.1
FCF Yield (%)	3.1	4.0	(0.8)	5.3	6.9
Dividend Yield (%)	0.8	1.3	1.3	1.6	2.0
EV/EBITDA (%)	29.9	18.0	11.0	8.2	6.3
EV/EBIT (%)	32.4	18.9	11.7	9.0	6.9

Income statement (MYRm)	**Dec-16**	**Dec-17**	**Dec-18F**	**Dec-19F**	**Dec-20F**
Total turnover	343	313	367	450	522
Gross profit	39	50	58	71	84
EBITDA	12	19	27	35	42
Depreciation and amortisation	(1)	(1)	(2)	(3)	(4)
Operating profit	11	18	26	32	39
Net interest	(1)	(0)	(1)	(1)	(1)
Income from associates & JVs	0	0	0	0	0
Exceptional income - net	(11)	(4)	0	0	0
Pre-tax profit	10	17	25	31	38
Taxation	(1)	(6)	(6)	(7)	(9)
Minority interests	(0)	(0)	(0)	(0)	(0)
Recurring net profit	20	16	19	24	29

Cash flow (MYRm)	**Dec-16**	**Dec-17**	**Dec-18F**	**Dec-19F**	**Dec-20F**
Change in working capital	(6.0)	(1.7)	13.7	(2.1)	(2.0)
Cash flow from operations	13.4	23.2	32.1	24.8	30.5
Capex	(2.0)	(8.4)	(35.0)	(5.0)	(5.0)
Cash flow from investing activities	(1.9)	(13.4)	(35.0)	(5.0)	(5.0)
Dividends paid	(1.1)	(2.3)	(5.5)	(5.8)	(6.4)
Cash flow from financing activities	4.4	5.4	39.3	(5.8)	(6.4)
Cash at beginning of period	19.0	34.4	49.0	85.4	99.4
Net change in cash	15.4	14.7	36.3	14.0	19.0
Ending balance cash	34.4	49.0	85.4	99.4	118.4

Balance sheet (MYRm)	**Dec-16**	**Dec-17**	**Dec-18F**	**Dec-19F**	**Dec-20F**
Total cash and equivalents	43	62	100	114	133
Tangible fixed assets	143	155	186	206	224
Intangible assets	6	6	6	6	6
Total investments	0	0	0	0	0
Total other assets	8	7	7	7	7
Total assets	200	230	300	333	370
Short-term debt	24	28	28	28	28
Total long-term debt	1	2	2	2	2
Other liabilities	108	121	133	149	163
Total liabilities	133	151	163	179	193
Shareholders' equity	67	78	136	154	177
Minority interests	0	0	(0)	(0)	(1)
Total equity	67	78	136	154	177
Net debt	(18)	(32)	(70)	(84)	(103)
Total liabilities & equity	200	230	300	333	370

Key metrics	**Dec-16**	**Dec-17**	**Dec-18F**	**Dec-19F**	**Dec-20F**
Revenue growth (%)	66.4	(8.7)	17.3	22.5	16.0
Recurrent EPS growth (%)	232.0	(21.2)	21.2	25.8	22.9
Gross margin (%)	11.4	16.0	15.8	15.9	16.0
Operating EBITDA margin (%)	3.4	6.0	7.5	7.8	8.1
Net profit margin (%)	5.8	5.0	5.1	5.3	5.6
Dividend payout ratio (%)	25.8	31.1	25.0	25.0	25.0
Capex/sales (%)	0.6	2.7	9.5	1.1	1.0
Interest cover (x)	13.3	23.6	24.1	30.1	36.9

Source : Company data, RHB

Valuation & Recommendation

We initiate coverage on KGB with a TP of MYR 1.41. Our TP is derived from a P/E valuation, supported by PEG and DCF methodology as a corroborative measure.

We ascribed a target P/E of 17x on our 2019F earnings. This takes into account the recently-completed share placement of 23m shares and warrant dilution, and is consistent with the average FY19 P/E of 17.2x for local semiconductor/technology peers.

The valuations are slightly ahead of the FBM Small Cap index's prospective P/E of 11x, which we think is justified given KGB's commendable 2-year core earnings CAGR of 24% and attractive PEG of 0.71x.

Our DCF assumptions are:

i. Risk free rate of 4% based on RHB's house assumption;

ii. Market risk premium of 5.6%, which is above the 4.4% in-house assumption to reflect liquidity risk;

iii. Market return of 9.6%;

iv. Beta of 1.2 based on Bloomberg adjusted Beta;

v. Terminal growth of 1.5%, which is well below the ASEAN GDP CAGR of 3.1% (2012-2017);

vi. Cost of equity of 10.7%;

vii. Cost of debt of 3.7%, in line with its historical cost of debt.

Figure 1: KGB's DCF valuation

FYE Dec (MYRm)	**FY19F**	**FY20F**	**FY21F**	**FY22F**	**FY23F**	**FY24F**	**FY25F**	**FY26F**	**FY27F**	**FY28F**
EBIT	32.0	39.1	44.9	51.6	58.8	67.2	76.4	86.9	99.1	113.0
EBIT*(1-tax rate)	24.3	29.7	34.1	39.2	44.7	51.1	58.0	66.1	75.3	85.9
Add: D&A	3.4	3.5	3.6	3.9	4.3	4.7	5.1	5.4	5.7	6.0
Less: WC investments (WC Inv)	-2.1	-2.0	-1.1	-1.4	-1.6	-2.0	-2.3	-2.8	-3.4	-4.0
Less: Fixed investments (FC Inv)	-35	-5	-5	-5	-10	-10	-10	-10	-10	-10
FCFF	-9.39	26.27	31.68	36.69	37.42	43.76	50.80	58.67	67.64	77.90
Disc. FCFF	-8.48	21.42	23.32	24.40	22.47	23.73	24.87	25.93	27.00	28.08
Terminal value at T=10	855.47									
PV of terminal value	308.36									
NPV	212.74									
Less Debt	-83.73									
Equity Value of Firm	437.38									
Equity Value per share (MYR)	**1.43**									
Implied 2019F P/E (x)	17									
Rf	4.0%									
Beta (x)	1.2									
Risk premium	5.6%									
Rm	9.6%									
TG (%)	1.5%									
CoE	10.7%									
CoD	3.7%									
WACC	10.7%									

Source: RHB

As the sole Malaysian company offering UHP and engineering services in China, we are forecasting a robust 2-year core earnings CAGR of 24%, on strong demand from China's semiconductor industry. In our view, the stock deserves a scarcity premium due to the lack of comparables domestically, and its unique business that offers growth as well as long-term recurring revenues.

KGB currently trades at 2019 P/E of 15.6x, a 10% discount to local tech peers' average of 17.2x (Figure 2). This, in our view, does not capture the superior growth of KGB's UHP segment, which is fuelled by rapid expansion in China's semiconductor/tech sector.

The bulk of KGB's revenues are from China, which incidentally is also the largest consumer of semiconductors globally. We believe KGB should at least trade on par with local technology proxies. Our target 2019 P/E of 17x reflects a 15% discount to international peers, which trade at an average FY19 P/E of 19.9x, on account of KGB's much smaller market capitalisation and lower stock liquidity.

KGB's unique business and exposure to the Chinese market sets it apart from its industrial peers in Malaysia. The company is a beneficiary of the ongoing US-China trade war, with the Chinese Government's "Made in China 2025" blueprint serving as a longer-term strategic impetus for growth at KGB.

Figure 2: Peer comparison

Company	Country	Price (Local Currency)	Mkt Cap (USDm)	P/E (x)			ROE (%)	P/BV (x)	NP Growth (%)	
				Actual	FY18	FY19	FY18	FY18	FY18	FY19
International										
Photronics Inc	United States	9.7	661.3	50.4	15.9	19.0	-	-	216.8	(16.2)
Iqe Plc	Britain	93.6	933.9	50.4	28.0	18.0	5.7	2.1	79.7	55.9
Park Electrochemical Corp	United States	18.3	370.5	18.0	47.3	35.3	-	-	(61.9)	33.9
Magnachip Semiconduct	South Korea	9.4	324.6	3.8	15.6	11.4	-	-	(75.6)	37.3
Axt Inc	United States	6.4	254.5	25.5	17.1	12.1	-	1.2	48.8	42.0
Aneka Gas Industri Tbk Pt	Indonesia	610.0	123.0	19.2	16.6	12.5	4.7	1.0	15.7	33.3
Marketech International	Taiwan	45.0	259.0	12.1	9.1	7.5	21.6	1.3	33.2	21.3
Flytech Technology Co Ltd	Taiwan	70.5	333.0	13.7	11.0	9.5	21.3	2.1	24.4	16.1
Dsp Group Inc	United States	11.7	261.4	(87.1)	44.6	33.9	3.4	-	(295.3)	31.4
Guangdong Chaohua Tech-A	China	2.4	318.3	58.3	29.2	22.8	4.2	1.3	99.4	28.0
Shenzhen Sinexcel Electric-A	China	14.3	281.7	41.3	33.0	25.9	-	-	25.1	27.8
Broadex Technologies Co Lt	China	32.1	382.5	32.4	35.0	27.0	11.3	4.1	(7.6)	29.9
Mkt. Cap Weighted Average				**27.5**	**25.5**	**19.9**	**5.5**	**1.2**		
Local										
Globetronics Technology	Malaysia	2.2	358.3	32.5	20.5	16.3	28.0	4.8	58.3	26.2
D&O Green Technologies	Malaysia	0.9	238.5	43.8	23.0	18.0	11.7	4.5	89.8	27.9
Inari Amertron	Malaysia	2.0	1,475.3	27.9	23.3	18.6	28.0	6.2	19.8	25.2
Unisem (M)	Malaysia	3.0	523.9	14.0	21.6	17.0	6.8	1.5	(35.3)	27.3
Malaysian Pacific Industries	Malaysia	10.8	516.0	16.4	15.8	13.5	12.0	1.9	4.2	16.6
Mkt. Cap Weighted Average				**25.4**	**21.4**	**17.2**	**21.0**	**4.5**		
Kelington Group	**Malaysia**	**1.2**	**75.3**	**18.8**	**17.0**	**15.6**	**21.0**	**-**	**62.1**	**31.8**

Note: Share price related data as of 8 Nov 2018
Source: Bloomberg, RHB

Investment Thesis

Made in China 2025 (MIC 2025)

MIC 2025 is China's industrial blueprint to transform the country into a technology powerhouse. It was introduced by Premier Li Keqiang in 2015, and bears resemblance to the Industrial 4.0 policy developed by Germany. With a monumental government allocation of an estimated USD140bn, the blueprint seeks to upgrade China's manufacturing capabilities across 10 key sectors including semiconductors. At the core of the blueprint is China's determination to be self-reliant via investments in class-leading manufacturing assets, infrastructure and technologies to take on the US, Korea and Japan.

China is the largest consumer of semiconductors with a 60% share of the global market. Semiconductor imports exceeded that of crude oil in 2015 according to data published by the CEIC. It is perhaps not surprising that the Chinese Government is making a concerted effort to grow its domestic chip-making capabilities to reduce reliance on imports, while addressing ongoing structural issues, notably rising labour cost and competition.

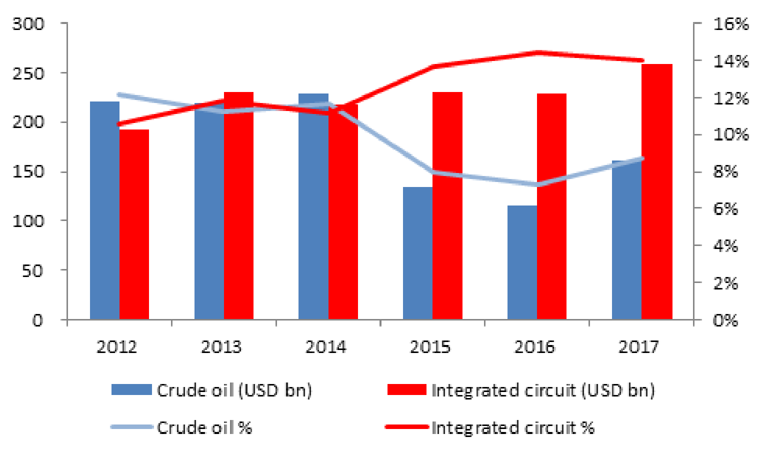
As China strives to become a global leader in chip production, significant upgrades are needed to boost its chip production capabilities. This involves the construction of world-class facilities and wafer foundries (fabs) to meet longer-term domestic demand. Under MIC 2025, China aspires to achieve a self-sufficiency rate of 40% for semiconductors by 2020, and 70% by 2025. In 2017, it attained less than half of the target for overall semiconductors used domestically.

We believe KGB is in a sweet spot to ride on China's semiconductor boom. The company's products and services are essential for the commissioning of wafer foundries and chip-making plants. This makes KGB an indirect proxy to the semiconductor industry. The company specialises in gas handling systems, which entails gas delivery, gas detection, facilities hook-up, and waste disposal, all of which are primarily applications in the semiconductor production value-chain. Given KGB's focus in a niche segment, coupled with high entry barriers, we believe it is well poised to capture the robust growth in China's semiconductor industry.

Over the longer term, we believe KGB's growth prospects will be supported by the use of artificial intelligence (AI), machine learning, and the internet of things (IOT), as well as increased usage of newer technologies. Though the bulk of current demand comes from the manufacturing sector, we expect demand for semiconductors to grow exponentially as China accelerates its Industry 4.0 plan.

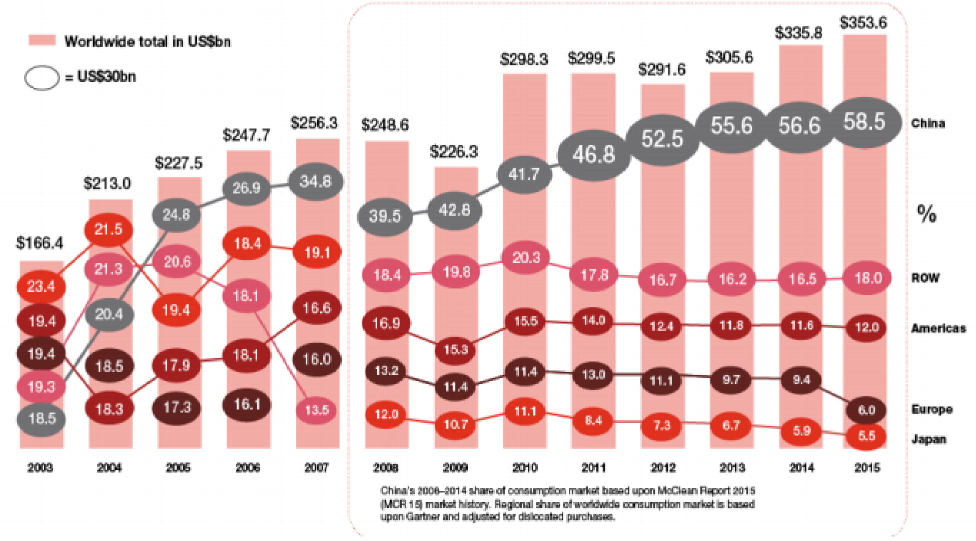
We expect KGB to post a robust 2-year CAGR of 24% on strong demand from the semiconductor industry. The industry grew at a CAGR of 19.3% from 2004 to 2017, largely on advancements within the smartphone industry, laptops, and other electronics.

Figure 3: Semiconductors top the list of imports for China



Source : CEIC

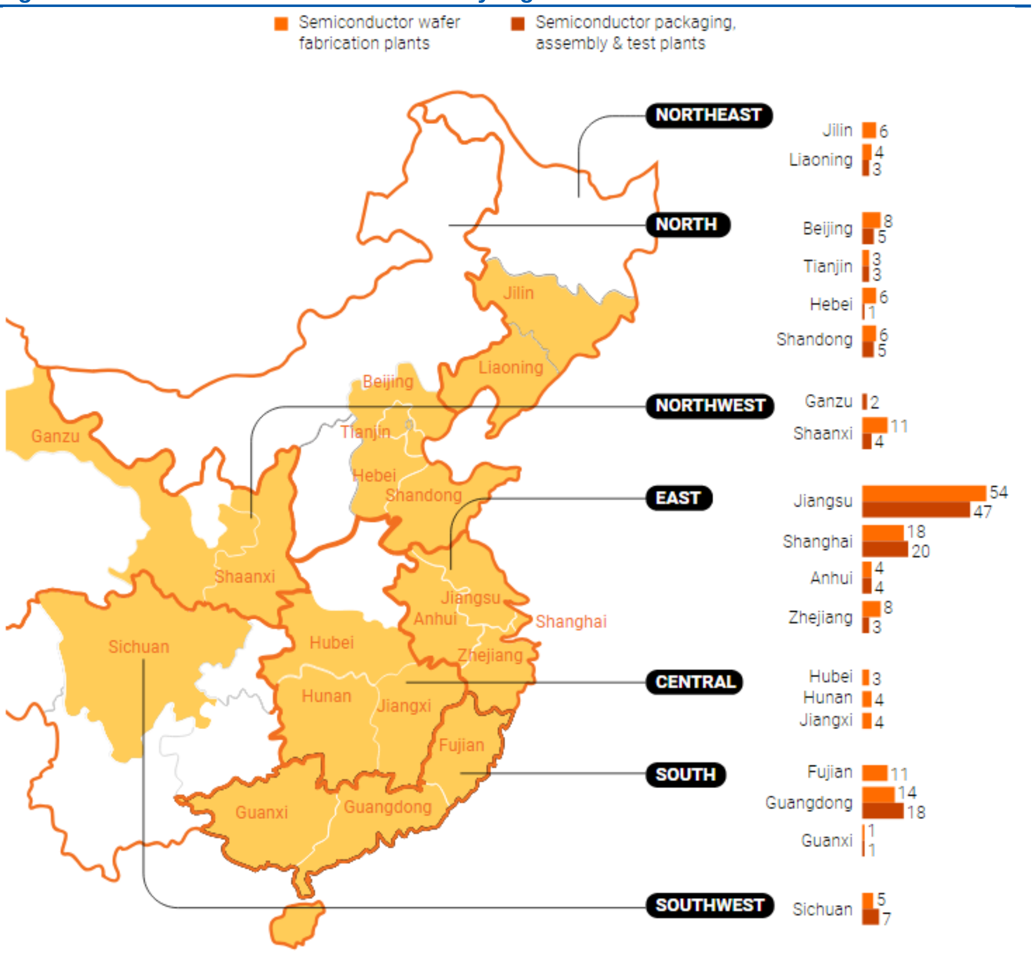
Figure 4: Worldwide semiconductor consumption by region, 2003-2015



Source: Pwc

According to the Semiconductor and Materials International's (SEMI) World Fab forecast, China is planning to build 19 new semiconductor fabs from 2017. This will consequently increase fab construction spending to a record high in 2017 and 2018, amounting to USD6.2bn and USD6.8bn, or over 50% of worldwide fab construction spending. With the US-China trade war in play, we expect the spending momentum to be sustained over the medium term.

Figure 5: China's semiconductor sector by region



Source: South China Morning Post

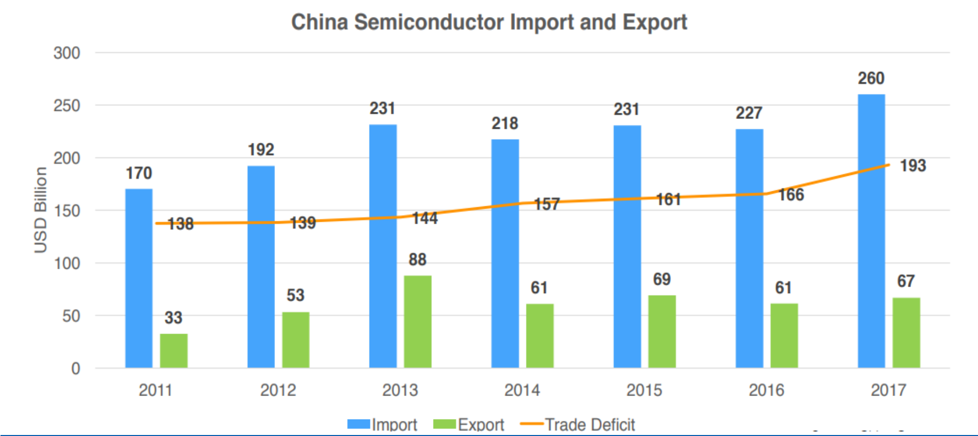
US-China trade war to accelerate China's technological independence…

In our view, the US-China trade war and issues surrounding the earlier sanctions imposed on China's ZTE Corp (763 HK, NR) will only accelerate China's resolve to become self-sufficient in terms of technology. The development should bode well for companies with a strong presence in China's semiconductor value–chain or companies that are directly involved in the fabrication and commissioning of advanced infrastructure for the chip-making industry.

According to the Nikkei Asian Review, an additional 25% tariff levied on imported goods from China will cost the semiconductor supply chain an additional USD20-30m, mainly from higher procurement costs. However, as a net importer of semiconductor products, we believe China's semiconductor sector will not be significantly affected by the recent headwinds or lower US demand.

In fact, we believe China will ramp up efforts to increase the production of semiconductors to meet domestic demand (China only produced 16% of its total domestic demand in 2017). Hence, the growth in domestic demand should be able to offset softening demand from the US, in our view.

Figure 6: China's semiconductor imports and exports, 2011-2017



Source: China Custom

….with KGB capitalising on the strong job momentum

KGB provides engineering solutions to ensure the safe handling of UHP gases and chemicals, which are core inputs for semiconductor manufacturing plants. Its PE segment is involved in the design, fabrication and maintenance of customised skids for large-scale plant constructions.

With its entrenched exposure in China, we believe KGB is well positioned to capitalise on soaring demand for the construction of new fabs and ancillary semiconductor facilities in China, as part of MIC 2025. We see KGB's track record and experience in the 'base-build' works – the backbone or building blocks of a foundry – as its key competitive advantage.

While there is competition from the likes of Taiwanese process engineering outfits and global process engineering solutions provider, Kinetics, we gather that these companies serve different market segments and there are more than enough projects to benefit all industry players. There are also opportunities for 'hook-up' jobs subsequently when the manufacturing facilities scale up, requiring additional connections to new tools and equipment.

In 1H18, revenue contribution from China nearly quadrupled YoY (+294% YoY) and accounted for almost half of KGB's revenue.

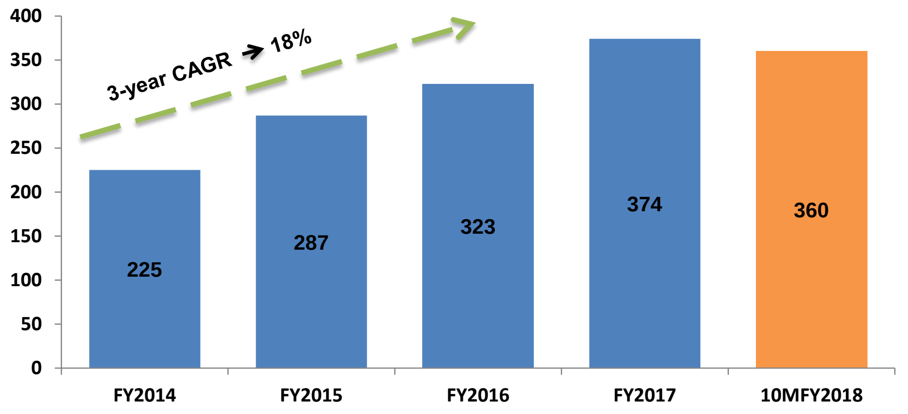
Respectable outstanding orderbook of MYR376m

We expect KGB's earnings growth to be supported by an outstanding orderbook of MYR376m (UHP, PE and GE) as at 10M18 (Figure 7). Historically, KGB's orderbook replenishment has been good, with an 18% CAGR of new jobs secured during 2014-2017.

KGB typically bids for MYR700m-1bn worth of jobs annually, with a success rate of 40-50%. YTD, new contracts secured have reached MYR360m, accounting for 96% of total orders secured for 2017 of MYR374m.

About 59% of its outstanding orderbook is derived from the UHP segment, followed by the PE (27%) and GC (13%) segments. This is on robust demand from China's semiconductor industry, and new jobs secured in Malaysia and Singapore.

Figure 7: KGB's orderbook replenishment



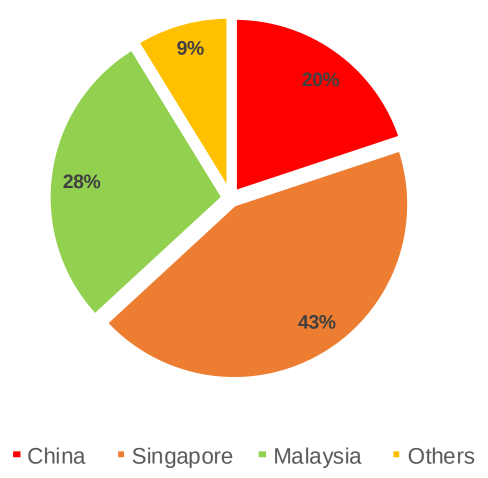
Source: Company data

Figure 8: Breakdown of outstanding orderbook (Oct 2018)

No	Client	Country	Segment	Outstanding orderbook (MYRm)
1	Yi Xing ZhongHuan	China	UHP	26
2	SMNC	China	UHP	20
3	Chengdu Construction	China	UHP	18
4	Linde SMIC	China	UHP	5
5	Contracts frm Global MNC semicon	China	UHP	3
6	Zhen Zhou He Jing	China	UHP	3
7	M+W Singapore (Micron)	Singapore	UHP	76
8	Qualcomm	Singapore	UHP	13
9	AMS	Singapore	UHP	10
10	Wyeth	Singapore	UHP	4
11	IFKM GR	Malaysia	UHP	16
12	Infineon	Malaysia	UHP	12
13	Hewlett-Packard	Malaysia	UHP	5
14	Western Digital	Malaysia	UHP	3
15	Silterra	Malaysia	UHP	2
16	Others - UHP		UHP	7
			SUB TOTAL	**223**
17	UIGC	Taiwan	PE	8
18	IME	Singapore	PE	19
19	Givaudan	Singapore	PE	2
20	JCT	Malaysia	PE	31
21	Stolthaven	Malaysia	PE	30
22	Synthomer	Malaysia	PE	3
23	Others - Process		PE	10
			SUB TOTAL	**103**
24	NUS WSB Project	Singapore	GC	21
25	Micron	Singapore	GC	16
26	Rolls Royce	Singapore	GC	2
27	PT Musim Mas	Indonesia	GC	3
28	B.Braun	Malaysia	GC	2
29	Others - Gen Con		GC	5
30	Industrial Gases	Malaysia	IG	2
			SUB TOTAL	**51**
			GRAND TOTAL	**376**

Source: Company data

Figure 9: Breakdown of outstanding orderbook by country (Oct 2018)



Source : Company data

A recent meeting with management indicated that contract pipelines and project flows from China should remain strong over the next 6-12 months, with KGB being more selective in its bids, focusing on higher-margin jobs where it has stronger expertise.

Given the robust outlook for new jobs in China, we expect KGB's orderbook replenishment rate to be sustained in 2019.

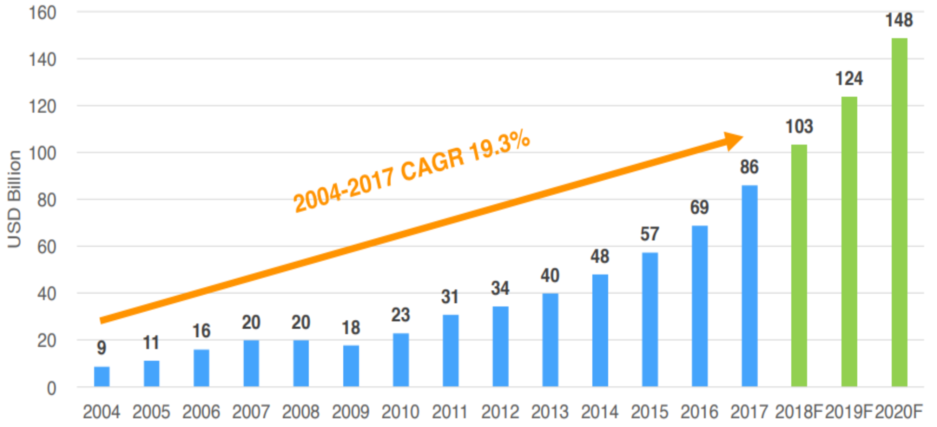
We are upbeat on its ability to secure new contracts in the UHP segment. In our earnings forecast, we have assumed 15% growth in new contracts pa from 2019F, to reflect the strong growth prospects in China's semiconductor sector, which is on track to hit a new high in 2018 according to SEMI.

Beyond that, we are confident of management's ability to secure new contracts premised on their strong technical knowhow.

The UHP segment generates superior margins compared to the PE and GC segments. This is largely attributed to the higher value-added components and domain expertise required for the niche segment.

KGB's gross profit margin (GPM) widened to 15.7% in 2017 from under 10% in 2015, helped by better project mix and a stronger orderbook at the UHP business. We expect its GPM to improve further going into 2020, when the LCO_2 plant starts contributing to total earnings.

Figure 10: Growth in China's semiconductor industry



Source: China Semiconductor Industry Association (CSIA)

New IGB to drive a new leg up in earnings from 2019

Management opted to venture into the production and distribution of industrial gases to supplement the core engineering services business, which is project-oriented and one-off in nature. The IGB operations would provide KGB with longer-term recurring revenues.

We view the IGB operations as a natural progression, as KGB started as a provider of UHP gases to the electronics and semiconductor industry. The company's founding members and major shareholders were also previous employees of Malaysian Oxygen (since renamed Linde Malaysia), Malaysia's largest producer of industrial gases.

KGB is in the process of building a CO_2 plant in Kerteh, Terengganu (adjacent to Petronas' gas processing plant), which upon completion in mid-2019, would have a rated production capacity of up to 50,000 tonnes per year.

In Nov 2017, KGB inked a 15-year deal with Petronas for the purchase of CO_2 waste gas, which would be purified for sale to end customers. The projected capex for the plant (including related assets such as storage vessels and liquid tankers) of MYR50- 60m will be funded via debt and proceeds from the recent share placement. More recently, KGB inked a MYR25m project financing from Malaysian Debt Ventures (MDV), which would also help to defray the cost of the plant.

While Linde Malaysia has an existing LCO_2 plant in Kerteh, we believe the market is big enough for a second player. We understand from management that existing LCO_2 supplies are not sufficient to meet domestic demand, with re-fillers sourcing their supply from Thailand where transportation costs are prohibitive.

As Linde Malaysia owns an existing cylinder refilling business, there are limitations as to how much more competitive it can price its LCO_2 products without cannibalising its own revenues. Here, we believe KGB's new plant and fleet of tankers would serve as an alternative source of supply for re-fillers, with prices that are reflective of more efficient production processes and transportation costs. To lower execution risks, management had already secured some off-take agreements with re-fillers, ahead of the plant's commencement.

KGB booked maiden revenue from the IGB operations in 1Q18, with the commencement of on-site supply of nitrogen gas to Hanwha QCells, one of the world's largest manufacturers of solar cells and modules. The contract involves the setting up of an on-site generator at Hanwha's manufacturing plant in Cyberjaya with a fixed facility fee of MYR20m over 10 years, as reflected in its outstanding orderbook.

We expect the IGB operations to drive a new leg of growth for KGB over the longer term, in the form of:

i. More on-site supply contracts;
ii. Distribution of liquid CO_2 .

The foray into industrial gas production and distribution would see KGB dislodging the dominant position held by Linde Malaysia, which controls some 90% of the industrial gas market domestically. We expect revenue contribution from IGB to show an exponential increase once the LCO_2 plant commences operations in 3Q19.

We project the LCO_2 plant to provide an additional MYR5m revenue uplift in 2019F, and MYR20m in 2020F, on the incremental ramp up in utilisation rate over a 5-year period.

The company continues to be on the lookout for more on-site gas supply projects and are in discussions with various parties, including M&A.

Management expects the IGB operations to generate c.MYR1bn in revenue over the plant's lifespan (15-20 years), which could translate into revenue of MYR50m pa beginning 2024.

Demand for liquid CO_2 should continue to be underpinned by healthy demand from the food and beverage industry over the longer term, and potentially other end user segments such as the steel/construction sector, oil and gas, and pharmaceutical industries.

Management is also eyeing the export markets such as Singapore, which is suffering from high manufacturing cost for CO_2, and a lack of competitive pricing.

Figure 11: KGB's liquid CO_2 and onsite gas supply unit under its industrial gas business

Source: Company

Key Risks

Key risks for the company include:

i. **Contract termination by major clients.** The UHP business involves contracts with major clients on a 6-9 months basis. Contract termination by a major client could negatively impact earnings. Nevertheless, UHP clients are typically sticky given KGB's strong track record and relationships with its key principals, which should mitigate downside risks;

ii. **Potential delays in the commencement of its liquid CO_2 plant.** The liquid CO_2 plant is set to commence operations in 3Q19. Any delays in the commencement could adversely affect potential earnings from its IGB operations, which offer high margins (30-40% at the gross margin level). Given that a supply agreement has been inked with a major national oil company, Petronas, we see execution risk as low;

iii. **Slower-than-expected implementation of China's industrial blueprint.** The slower execution of MIC 2025, delays in infrastructure projects, and competition could crimp KGB's orderbook and earnings growth. KGB will be directly impacted since 77% of 1H18 revenue was generated at its UHP segment, with the bulk from China;

iv. **Incidences at the semiconductor manufacturing plant.** KGB's UHP segment is directly involved in the delivery of harmful and flammable gases from storage tanks to wafer fab production lines. If there are any major accidents due to pipe leakages, it could potentially hurt KGB's franchise and affect contract flows.

Financial Overview

Strong jump in revenue and earnings in 1H18

KGB reported a strong 38% YoY jump in headline PATAMI to a record MYR12.3m in 2017. This came on the back of good cost management efforts and the focus on higher-margin projects. Consequently, GPM widened to 15.7% in 2017 from under 10% in 2015.

Stripping-out impairment losses (on projects and receivables) totalling MYR10.9m and MYR3.8m, core earnings fell 19% YoY in 2017, mainly due to higher tax expense (from the cessation of the pioneer status of a subsidiary) and prior year tax adjustments.

For 1H18, KGB's revenue and core earnings rose 39% YoY and 73% YoY, mainly driven by the UHP segment with continuing strong momentum from projects in China. The overall growth continues to be underpinned by the UHP/PE segments, which collectively made up over 60% of revenue. Malaysia, Singapore and China accounted for 45%, 25% and 18% of 2017 group revenue.

Going forward, we are projecting a revenue CAGR of 19% for 2018F-2020F, while core earnings are expected to grow at a CAGR of 24.3% to MYR30.8m in 2020F. Earnings growth will be supported by:

i. Healthy orderbook replenishment;

ii. Focus on more profitable projects;

iii. Foray into the higher-margin IGB operations.

Given that KGB's overseas operations are carried out in the respective currencies, the company also enjoys a natural hedge against currency volatility.

KGB's cost structure comprises mainly raw materials (60%) and labour (40%). Due to the nature of its business where almost half of its revenues are derived from China, its earnings are susceptible to CNY volatility. Our sensitivity analysis indicates that every 10% change in the MYR/CNY exchange rate would impact revenue by c.5%, all else being equal.

We are projecting capex of MYR35m for 2018F, mainly for the new liquid CO_2 plant, with maintenance capex of MYR10m in subsequent years.

Strong net cash balance sheet

KGB had a net cash balance of MYR39.9m as at 2Q18. That said, we expect its gross gearing to rise slightly to 0.4x in 3Q18 from 0.2x in 2Q18, following the MDV debt drawdown. The company also recently completed a placement exercise of 22m shares with proceeds of over MYR17m. Additionally, KGB stands to gain MYR22.8m from the proceeds of the exercise of 54m warrants that will expire in mid-2019.

KGB intends to utilise the MYR25m MDV loan to partly finance the construction, design, operations and maintenance of the LCO_2 plant. Management also intends to use the proceeds to finance the cost of purchasing CO_2 equipment to be installed at the plant. The MDV loan will only partly finance the total capex of MYR50-60m to develop the LCO_2 plant, in our view. The rest of the capex commitment will be funded internally.

Terms and conditions for the MDV loan include a corporate guarantee in favour of MDV, an irrevocable letter of undertaking to provide cash injection in the event of cost overruns during the construction period, regularisation of facility instalment, and a financing service reserve account and/or cash shortfall during the tenure of the facility.

The company has a policy of distributing 25% of its PATAMI as dividends. We expect a similar dividend payout to continue going forward, supported by the venture into IGB and an improving EBITDA profile.

Figure 12: KGB's 2Q18 and 1H18 results

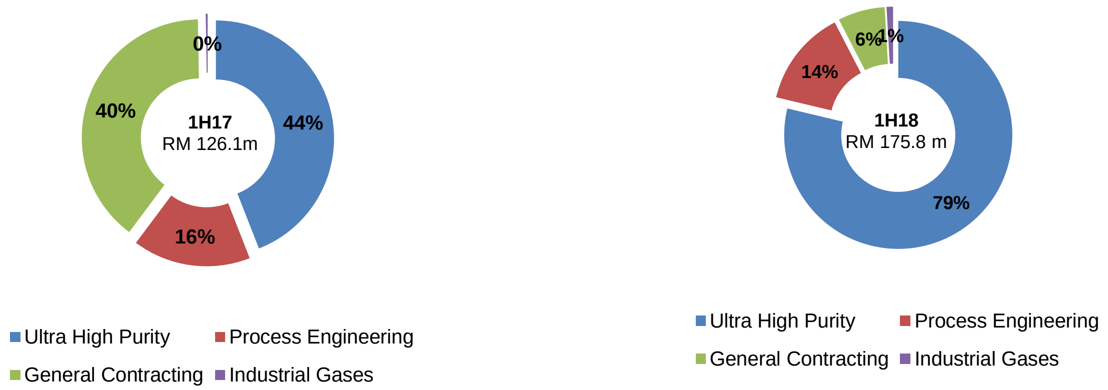
FYE Dec (MYRm)	2Q17	1Q18	2Q18	QoQ (%)	YoY (%)	1H17	1H18	YoY (%)
Revenue	**69.6**	**86.5**	**89.2**	**3%**	**28%**	**126.1**	**175.8**	**39%**
EBIT	**2.8**	**6.7**	**5.5**	**-18%**	**95%**	**5.4**	**12.3**	**127%**
EBIT margin (%)	*4%*	*8%*	*6%*			*4%*	*7%*	
Other income	(0.6)	0.6	0.2	-68%	130%	0.3	0.8	155%
Finance Costs	(0.2)	(0.3)	(0.3)	7%	-69%	(0.3)	(0.6)	-77%
Pretax profit	**2.7**	**6.4**	**5.2**	**-19%**	**97%**	**5.1**	**11.7**	**131%**
Pretax margin (%)	4%	7%	6%			4%	7%	
Tax	(0.3)	(2.2)	(0.9)	60%	-162%	(0.7)	(3.1)	-343%
Effective tax rate (%)	13%	35%	17%			14%	27%	
Minority interest	(0.0)	(0.0)	(0.1)	-288%	-195%	0.1	0.1	-47%
Net Profit	**2.3**	**4.2**	**4.4**	**4%**	**88%**	**4.4**	**8.6**	**95%**
Core Profit	**3.1**	**2.7**	**5.3**	**94%**	**71%**	**4.7**	**8.0**	**72%**
Core net margin (%)	*4%*	*3%*	*6%*			*4%*	*5%*	

Source: Company data

Figure 13: Revenue breakdown by geography – 1H17 and 1H18

Source: Company data

Figure 14: Revenue breakdown by segments – 1H17 and 1H18



Source: Company data

Company Overview

Background

KGB was founded in 1999 and listed on the Main Board of Bursa Malaysia in 2012. The company's business activities are categorised into four main segments:

i. UHP segment that ensures safe handling of UHP gases and chemicals;

ii. Process engineering that involves plant design, fabrication and maintenance;

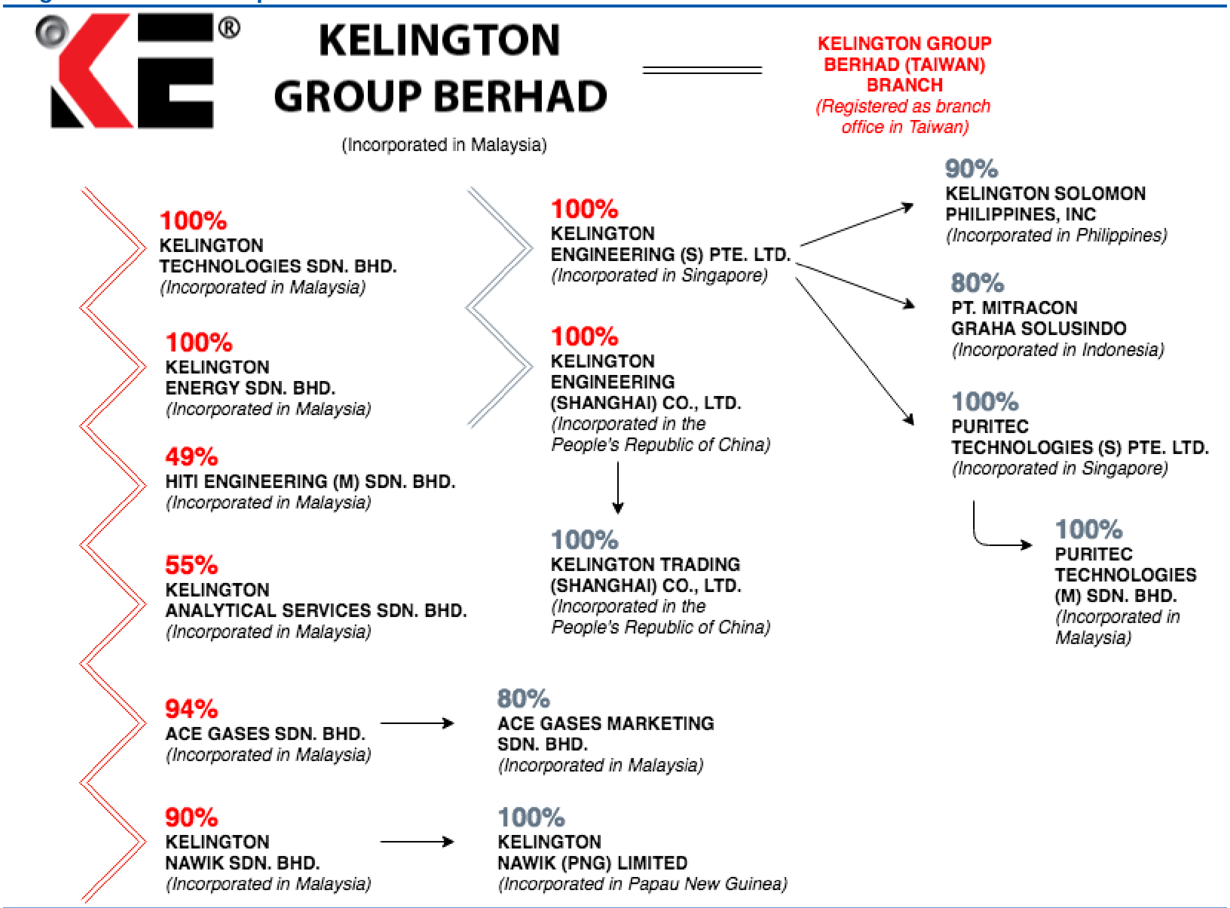
iii. General contracting works providing civil and mechanical engineering services;

iv. Industrial gases where it manufactures and trades industrial gases.

Its clientele includes leading names in the semiconductor space including Global Foundries, United Industrial Gases, Infineon Technologies and Micron Technology.

The company is helmed by its CEO, Ir. Gan Hung Keng who is also KGB's founder. Palace Star, which holds a 36% stake in KGB, is controlled by both the CEO and COO, Mr Ong Weng Leong.

Figure 15: KGB's corporate structure



Source: Company data

UHP division

Under the UHP segment, the company undertakes various services including the bulk/special gas delivery system, chemical delivery system, gas detection, hook-up facilities, and exhaust system for gas disposal. The China market contributed the bulk of UHP projects making up 49% of 1H18's revenue.

KGB's expertise in the design and fabrication of UHP delivery systems for the semiconductor industry is a key competitive advantage with China seeking to gain technological independence under MIC 2025. KGB's major customers include Semiconductor Manufacturing International Corporation (SMIC), Taiwan Semiconductor Manufacturing Company (TSMC) and Infineon Technologies.

KGB's foray into China was made possible by the strong relationship forged with its second largest shareholder, Lien Hwa (via Sun Lead International), a Taiwanese conglomerate, which has been with the company since inception.

Figure 16: KGB's UHP business segment

Source: Company

Figure 17: KGB's client list

Source: Company data

IGB segment

In Feb 2018, KGB completed its first on-site supply contract for the delivery of nitrogen gas (N_2) to Hanwha QCells, one of the world's largest manufacturers of solar cells and modules. The contract, valued at MYR20m, will provide a steady stream of recurring revenue over a 10-year period. The diversification into IGB is a conscious effort by management to develop longer-term earnings visibility for the company.

KGB has also inked a 15-year supply agreement with Petronas to purchase residual/waste CO_2, and is in the midst of constructing a liquid CO_2 plant in Kerteh, Terengganu. Upon completion in mid-2019, the facility would have a rated production capacity of 50,000 tonnes pa, making KGB the second largest liquid CO_2 supplier in the country after Linde Malaysia. The plant is capable of refining high quality liquid CO_2 that meets the stringent standards and requirements of the F&B industry, a key customer segment.

Although Lien-Hwa has an existing tie-up with Linde (Linde Lien Hwa) and is the largest producer of industrial gases in Taiwan, we understand from management that there is no conflict of interest, and it does not compromise KGB's existing businesses and/or plans for future expansion.

Figure 18: KGB's list of potential clientele for IGB

Source: Company data

PE and GC segments

Under its process engineering segment, KGB is involved in the engineering and construction of mechanical and electrical system that supports industrial processes across many sectors. These include tankage construction and erection, equipment fabrication, steel structure fabrication and industrial process plant and underground pipeline. Generally, its work scope involves the design, fabrication, installation and commissioning under the process engineering segment.

KGB is also involved in general contracting, in that it specialises in civil construction work and clean room construction. Notable projects under its process engineering and general contracting segments include the supply and installation of a mild steel tank for Pengerang Terminal, and the design, supply and installation of temporary facilities for workers in BASF Petronas Chemical. Both the process engineering and general contracting segments contributed 20% of KGB's 1H18 revenue.

Key management team

Ir Gan Hung Keng, chief executive officer. Mr Gan founded the company, and has been the executive director and chairman since 14 Feb 2000. He assumed the role of CEO with effect from 1 Sep 2009. He graduated with a Bachelor of Chemical and Process Engineering degree from Universiti Kebangsaan Malaysia. He is also a Professional Engineer on the Board of Engineers, Malaysia. Prior to founding the company, he led various engineering projects, including the Ultra Clean Division for Malaysian Oxygen (MOX), and Ultra Clean System at Eastern Oxygen, having approximately 12 years of experience cumulatively. Expertise in the detailed designing of all gas delivery systems (inert and hazardous gases) for Semiconductor Wafer Fabrication and Flat Panel Display plants, engineering and construction management of large scale and fast track project for gas and chemical related projects, and general management of a business unit and a company.

Mr Ong Weng Leong, chief operating officer. Mr Ong was appointed as director since 22 Nov 2004 and general manager on 1 Aug 2005, and was subsequently re-designated as chief operating officer since 1 Sep 2009. He graduated with a Bachelor of Chemical Engineering degree from Universiti Teknologi Malaysia, Malaysia, and a Master in Business Administration from the University of Bath, United Kingdom. He is also a fellow member of Malaysian Institute of Management and a member of the ESS Committee. Prior to joining the company, he held managerial positions in MOX since 1996. Expertise in detailed designing of all gas systems ranging from gas production plants to the supply stations of customers and engineering construction management of industrial gas related projects.

Mr Chan Thian Kiat, senior independent non-executive director. Mr Chan was appointed as an independent non-executive director on 11 Sep 2009, subsequently re-designated as senior independent non-executive director on 29 Apr 2013. He is also the Chairman of the Audit Committee. He graduated from the University of Melbourne with a Commerce degree, and is also a fellow of CPA Australia as well as an Associate of the Institute of Chartered Secretaries and Administrators (ACIS). His expertise falls under corporate finance, providing consultancy services and assistances in debt and equity capital raising and mergers and acquisitions.

Mr Tan Chuan Yong, senior independent non-executive director. Mr Tan was appointed as an independent non-executive director on 11 Sep 2009, subsequently re-designated as senior independent non-executive director on 29 Apr 2013. He is the Chairman of the Nomination Committee. He is also a member of the Audit Committee, Remuneration Committee and ESS Committee. He holds a Barrister-at-Law from the Honourable Society of Lincoln's Inn. He was admitted to the English Bar in 1982 and the Malaysian Bar in 1983. He is currently an Advocate & Solicitor and practising as a Partner in Messrs Tan Chuan Yong & S.M. Chan, Advocates & Solicitors. He has been a member of the Malaysian Bar since 1983. He is also a Notary Public.

Datuk Haji Jamil bin Haji Osman, independent non-executive director. Vice Admiral (Retired) Datuk Haji Jamil bin Haji Osman was appointed to the Board as an Independent Non-Executive Director on 25 Jun 2012. He is the Chairman of the Remuneration Committee and a member of the Nomination Committee. Prior to his retirement, he was the RMN Fleet Commander in charge of the marine operations and responsible for the sovereignty of Malaysia Maritime Area.

Mr Soo Yuit Weng, independent non-executive director. Mr Soo Yuit Weng was appointed as an Independent Non-Executive Director on 1 Feb 2013. He is also a member of the Audit Committee, Remuneration Committee and Nomination Committee. He holds a Bachelor of Economics from Monash University, Australia majoring in Accounting. He is a member of Malaysian Institute of Accountants (MIA) and a fellow of Chartered Tax Institute of Malaysia (CTIM). Mr Soo is also a licensed Auditor and Tax Agent in Malaysia. He is a Chartered Accountant and is currently practicing under his own firm namely Y W Soo & Co. Prior to that, Mr Soo was attached to various professional firms and has in-depth experience in the field of audit and taxation.

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