October 16, 2018

Maybank IB Research

Frontken Corp. Bhd (FRCB MK)

Next level of growth

BUY

Share Price	MYR 0.88
12m Price Target	MYR 1.01 (+15%)
Previous Price Target	*MYR 0.69*

Still more upside, maintain BUY

The recent retracement in Frontken's share price provides buying opportunity. We raise our earnings forecast by 5%-16% for FY18E-20E on more high value work orders, riding on positive demand for Customer X's 7nm chips. Hence, our TP is raised to MYR1.01 (from MYR0.69), pegged to higher PER of 18.8x FY19 EPS (1 SD above its 5-yr mean) (previously 15x at 0.5 SD), supported by higher 3-year (FY17-20E) earnings CAGR forecast of 25% (previously 17%). Maintain BUY.

Benefitting from 7nm development

We expect Frontken to be busy with more precision cleaning works in 2HFY18 and FY19, with the production ramp-up of its Customer X's 7nm chips in Taiwan. Customer X is currently the only foundry offering this advanced process, which should put it at the forefront in the global semiconductor market for the production of high-performance electronic chips. We also think Customer X will continue to dominate the market with the lion's share in CY19-20 although Samsung is expected to start production of 7nm chips in 2HCY19 due to its first-mover advantage.

Customer X's 7nm production to be fully loaded

Our Regional Technology analyst, Stefan Chang, expects Frontken's Customer X to increase its 7nm wafer shipment to approximately 1m units in FY19E from 0.4m units (for a 6-month period) in FY18E. We expect the volume will be mostly for Apple (about 400k units), Qualcomm (about 150k-200k) and Huawei (about 120k-150k). We also expect AMD to use Customer X's 7nm chips (about 100k) exclusively for the production of its new GPU (Vega) and CPU (Rome) products in 4Q18 and 2Q19 respectively. We think Customer X has benefited from AMD's preferred partner for CPU, Global Foundries' decision to end 7nm development due to financial concerns. AMD currently uses Customer X's 28nm/16nm for its gaming APU.

Revising up earnings forecasts

Pursuant to the above, we raise Frontken's Taiwan revenue estimate by 3-13% to MYR203m-272m for FY18E-20E. We also expect better contribution from its Singapore semiconductor segment of MYR76.7m in FY20E on more work orders due to significant memory chips production at its major customer's new fabrication plant there. As such, these increase our earnings forecasts by 12%/16%/5% in FY18E/19E/20E.

FYE Dec (MYR m)	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	262	297	332	390	457
EBITDA	51	65	86	101	116
Core net profit	18	34	45	56	67
Core EPS (sen)	1.7	3.3	4.3	5.4	6.4
Core EPS growth (%)	202.2	92.7	32.0	23.3	18.9
Net DPS (sen)	0.0	0.5	0.9	1.1	1.3
Core P/E (x)	10.0	14.0	20.3	16.4	13.8
P/BV (x)	0.7	1.7	2.9	2.5	2.2
Net dividend yield (%)	0.0	1.1	1.0	1.2	1.4
ROAE (%)	8.0	11.0	15.2	16.5	17.1
ROAA (%)	4.5	8.2	10.2	11.4	11.9
EV/EBITDA (x)	2.7	6.3	9.4	7.5	6.0
Net gearing (%) (incl perps)	net cash	net cash	net cash	net cash	net cash
Consensus net profit	-	-	43	52	58
MKE vs. Consensus (%)	-	-	5.7	8.7	14.0

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Company Description

Frontken specialises in engineering and precision cleaning services, mostly for semiconductors and O&G markets in Taiwan, Singapore and Malaysia.

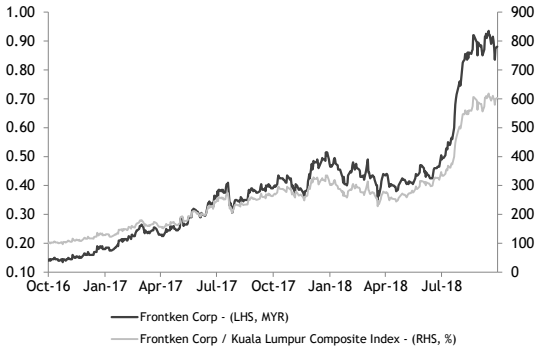
Statistics

52w high/low (MYR)	0.94/0.35
3m avg turnover (USDm)	3.4
Free float (%)	20.0
Issued shares (m)	1,053
Market capitalisation	MYR927.0M
	USD223M

Major shareholders:

Dazzle Clean Ltd	27.8%
Ooi Keng Thye	14.5%
CIMB-Principal Asset Management	5.2%

Price Performance



	-1M	-3M	-12M
Absolute (%)	(2)	89	126
Relative to index (%)	2	88	129

Source: FactSet

Fig 1: Apple's 7nm A12 chip to power iPhone XS, XR & XS Max

Source: Company data

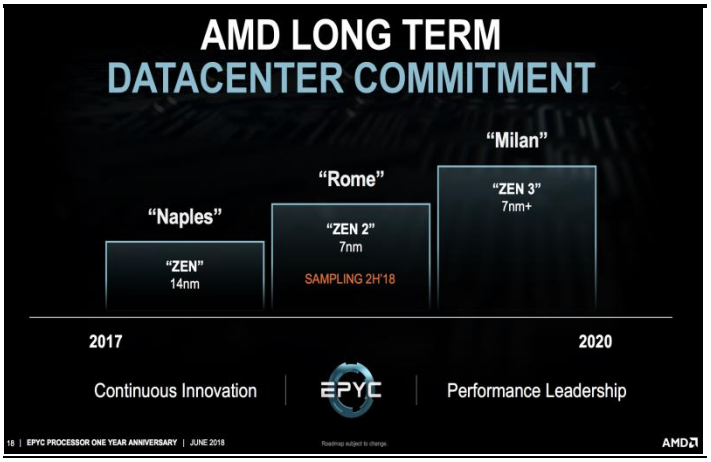
Fig 2: Qualcomm's 7nm s855 chip for Android flagship model

Source: Company data

Fig 3: Huawei's 7nm Kirin 980 chip to power Mate 20 series

Source: Company data

Fig 4: AMD's roadmap of 7nm CPU



Source: Company data

Fig 5: 1-year forward PER

Source: Bloomberg

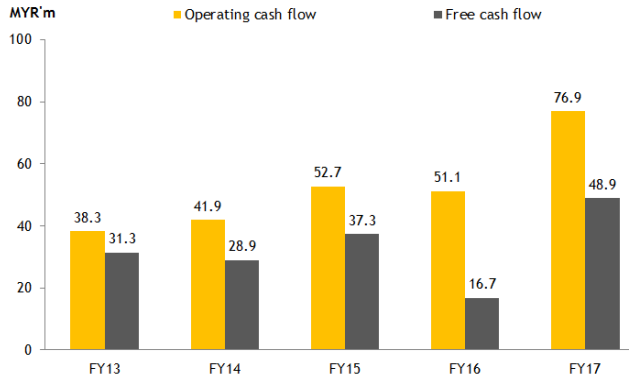
Fig 6: 1-year forward PBV

Source: Bloomberg

Value Proposition

- Frontken is a leading service provider of cleaning and coating of high-tech equipment in Malaysia and Taiwan.
- Group earnings have reached an inflection point with growth to pick up from increasing demand for chips and the recovery of O&G industries.
- High barriers to entry for precision cleaning services due to stringent customer compliance that require in-depth knowledge, skills and expertise.
- Highly cash generative with operating cash flow last year of MYR69m against net profit of MYR34m (depreciation MYR18m) and FCF MYR49m (FCF yield 10.9%).
- ROE has continued to improve from 4.3% in FY15 to 13.4% in FY17, through better profit margins.

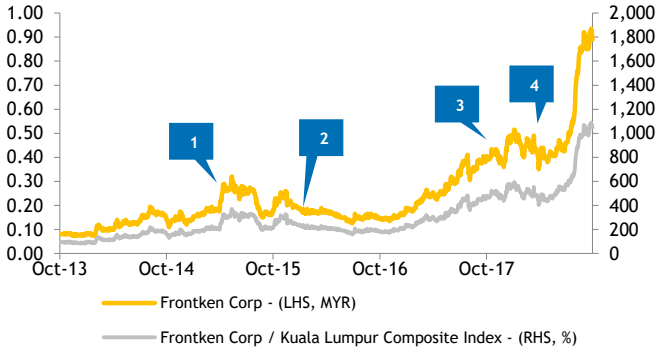
Sustainable FCF and OCF



Source: Company, Maybank KE

Price Drivers

Historical share price trend



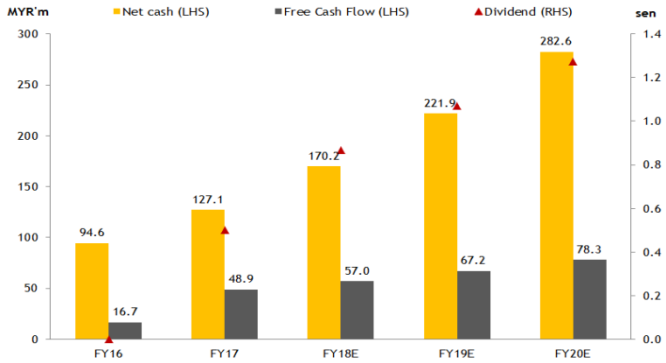
Source: Company, FactSet, Maybank Kim Eng

1. Achieved higher revenue due to the ramp-up in semiconductor business in Taiwan and recognition of one-off EPCC project, which was ATB project at Tanjung Bin.
2. Slump in oil and gas price naturally affected production and maintenance activities, coupled with unfortunate cost overrun in its ATB project.
3. The global semiconductor market grew at an impressive rate throughout 2017 (+21.6% YoY), posting highest-ever annual sales.
4. The start of a slowdown in global sales of smartphones to end users.

Financial Metrics

- We expect Frontken's revenue to continue to grow in the next three years on increasing demand for chips.
- Higher profit margins due to better services fees for handling complex process of advance wafer fabrication process from 16nm and beyond.
- Net cash position (10sen/sh) in FY17 on low borrowings and strong cash flow.
- The Group resumed a dividend last year of 0.5sen, equal to a 17.5% payout ratio. We forecast a 20% payout ahead, supported by strong FCF and an increasing net cash position in FY18E-20E.

Net cash and strong FCF to support higher dividend payout



Source: Company data, Maybank KE

Swing Factors

Upside

- Higher utilisation rate of wafer fabrication equipment and capacity expansion of logic foundry and memory companies.
- Higher-than-expected chip demand from other markets, such as automotive, artificial intelligence etc.
- Rally in oil prices and higher capex that can spur O&G activities.

Downside

- Lower utilisation rate on tapering demand for smartphones and electronic devices.
- Lack of development in other markets and investment on new advanced technological nodes.
- Sharp fall in oil prices and industry capex leads to lower O&G sector demand for services.

FYE 31 Dec	FY16A	FY17A	FY18E	FY19E	FY20E
Key Metrics					
P/E (reported) (x)	8.3	11.1	20.3	16.4	13.8
Core P/E (x)	10.0	14.0	20.3	16.4	13.8
P/BV (x)	0.7	1.7	2.9	2.5	2.2
P/NTA (x)	nm	nm	nm	nm	nm
Net dividend yield (%)	0.0	1.1	1.0	1.2	1.4
FCF yield (%)	9.4	10.1	6.2	7.3	8.6
EV/EBITDA (x)	2.7	6.3	9.4	7.5	6.0
EV/EBIT (x)	4.1	8.8	12.0	9.2	7.1
INCOME STATEMENT (MYR m)					
Revenue	261.8	296.6	332.5	390.3	456.5
Gross profit	78.5	104.8	142.0	172.3	201.5
EBITDA	51.0	64.8	85.6	101.0	116.4
Depreciation	(17.2)	(18.5)	(18.5)	(18.5)	(18.5)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	33.8	46.3	67.1	82.5	97.9
Net interest income /(exp)	(0.4)	(0.1)	(0.4)	(0.3)	(0.3)
Associates & JV	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Exceptionals	0.0	0.0	0.0	0.0	0.0
Other pretax income	0.0	0.0	0.0	0.0	0.0
Pretax profit	33.3	46.1	66.6	82.1	97.6
Income tax	(6.1)	(9.7)	(15.3)	(18.9)	(22.4)
Minorities	(7.2)	(6.6)	(5.8)	(7.2)	(8.5)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	20.0	29.9	45.5	56.1	66.6
Core net profit	17.9	34.5	45.5	56.1	66.6
BALANCE SHEET (MYR m)					
Cash & Short Term Investments	102.5	129.3	172.5	224.1	285.5
Accounts receivable	101.2	97.0	98.6	115.7	135.3
Inventory	11.0	13.5	12.0	13.7	16.0
Reinsurance assets	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equip (net)	152.1	150.0	139.5	129.0	118.5
Intangible assets	33.8	33.8	33.8	33.8	33.8
Investment in Associates & JVs	2.0	2.0	1.9	1.9	1.8
Other assets	5.3	5.5	5.5	5.5	5.5
Total assets	**407.8**	**431.1**	**463.7**	**523.7**	**596.5**
ST interest bearing debt	8.7	16.9	15.1	13.6	12.2
Accounts payable	73.3	79.6	74.4	86.3	101.3
Insurance contract liabilities	0.0	0.0	0.0	0.0	0.0
LT interest bearing debt	20.6	11.7	10.4	9.4	8.4
Other liabilities	10.0	17.0	17.0	17.0	17.0
Total Liabilities	**112.4**	**125.1**	**116.7**	**126.1**	**138.8**
Shareholders Equity	261.6	281.6	318.0	362.8	416.2
Minority Interest	33.8	24.4	29.0	34.7	41.6
Total shareholder equity	**295.4**	**306.0**	**347.0**	**397.6**	**457.7**
Total liabilities and equity	**407.8**	**431.1**	**463.7**	**523.7**	**596.5**
CASH FLOW (MYR m)					
Pretax profit	33.3	46.1	66.6	82.1	97.6
Depreciation & amortisation	17.2	18.5	18.5	18.5	18.5
Adj net interest (income)/exp	0.4	0.1	0.4	0.3	0.3
Change in working capital	1.1	6.9	(5.3)	(6.9)	(7.0)
Cash taxes paid	(6.7)	(7.9)	(15.3)	(18.9)	(22.4)
Other operating cash flow	(0.9)	5.4	0.1	0.1	0.1
Cash flow from operations	44.4	69.0	65.0	75.2	87.0
Capex	(27.7)	(20.2)	(8.0)	(8.0)	(8.0)
Free cash flow	16.7	48.9	57.0	67.2	79.0
Dividends paid	(2.2)	(7.2)	(10.3)	(12.6)	(15.0)
Equity raised / (purchased)	(0.1)	0.0	0.0	0.0	0.0
Change in Debt	(15.1)	(0.2)	(3.2)	(2.5)	(2.3)
Other invest/financing cash flow	(8.5)	(12.9)	(0.4)	(0.3)	(0.3)
Effect of exch rate changes	3.3	2.0	0.0	0.0	0.0
Net cash flow	(5.7)	30.6	43.1	51.7	61.4

FYE 31 Dec	FY16A	FY17A	FY18E	FY19E	FY20E
Key Ratios					
Growth ratios (%)					
Revenue growth	(6.7)	13.3	12.1	17.4	17.0
EBITDA growth	46.5	26.9	32.2	18.0	15.2
EBIT growth	102.7	36.8	45.0	22.9	18.7
Pretax growth	108.4	38.4	44.3	23.3	18.9
Reported net profit growth	400.1	49.0	52.3	23.3	18.9
Core net profit growth	204.4	92.7	32.0	23.3	18.9
Profitability ratios (%)					
EBITDA margin	19.5	21.8	25.8	25.9	25.5
EBIT margin	12.9	15.6	20.2	21.1	21.4
Pretax profit margin	12.7	15.6	20.0	21.0	21.4
Payout ratio	0.0	17.5	20.0	20.0	20.0
DuPont analysis					
Net profit margin (%)	7.7	10.1	13.7	14.4	14.6
Revenue/Assets (x)	0.6	0.7	0.7	0.7	0.8
Assets/Equity (x)	1.6	1.5	1.5	1.4	1.4
ROAE (%)	8.0	11.0	15.2	16.5	17.1
ROAA (%)	4.5	8.2	10.2	11.4	11.9
Liquidity & Efficiency					
Cash conversion cycle	19.1	(0.3)	(15.6)	(12.7)	(12.4)
Days receivable outstanding	133.6	120.3	105.9	98.8	99.0
Days inventory outstanding	22.4	23.0	24.1	21.2	21.0
Days payables outstanding	136.8	143.5	145.5	132.7	132.4
Dividend cover (x)	nm	5.7	5.0	5.0	5.0
Current ratio (x)	2.5	2.2	2.8	3.2	3.5
Leverage & Expense Analysis					
Asset/Liability (x)	3.6	3.4	4.0	4.2	4.3
Net gearing (%) (incl perps)	net cash	net cash	net cash	net cash	net cash
Net gearing (%) (excl. perps)	net cash	net cash	net cash	net cash	net cash
Net interest cover (x)	89.6	nm	nm	nm	nm
Debt/EBITDA (x)	0.6	0.4	0.3	0.2	0.2
Capex/revenue (%)	10.6	6.8	2.4	2.0	1.8
Net debt/ (net cash)	(73.1)	(100.7)	(147.0)	(201.2)	(264.9)

Source: Company; Maybank

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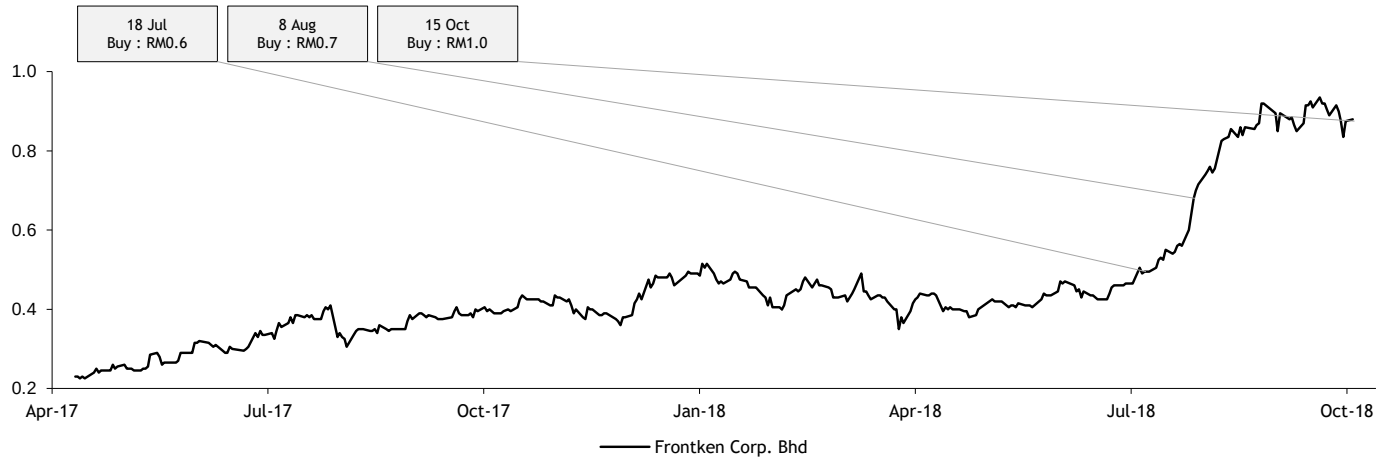

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