May 8, 2019

Maybank IB Research

Frontken Corp. Bhd (FRCB MK)

Upcycle industries euphoria

BUY

Share Price	MYR 1.32
12m Price Target	MYR 1.85 (+40%)
Previous Price Target	*MYR 1.58*

Improving fundamentals come with higher PER

There is much excitement over (i) the rollover of its Customer X's advanced technologies process to 7+nm this year, 6nm and 5nm next year, (ii) growth in memory and sensors consumption and (iii) the ramp-up in local O&G activities from 2Q19. Set against this favourable backdrop, higher valuations are warranted, in our view, and we peg our FY20E EPS to a higher PER of 23.5x (from 20x PER) based on +1.5std above the mean, while maintaining our earnings forecasts for now. Still a BUY with a higher TP of MYR1.85 (+27sen).

Topline still driven by the semiconductor segment

Following from a recent meeting, management shared its 1Q19 revenue segmental breakdown by industry for the first time to provide a better picture of its revenue portfolio. The Group's 1Q19 revenue of MYR83.8m (+18% YoY) was 77% driven by the semiconductor segment (+12% YoY) and the rest was from the O&G segment (+51% YoY) (Fig. 3). Management also broke down further its 1Q19 revenue contribution from its semiconductor segment by technological nodes (Fig. 4).

Technological edge driving the growth

Management expects better works visibility in 2H19 in view of full utilization of its Customer X's 7nm and 7+nm for its customers' new model (i.e. Apple and AMD) launches this year. Management also posits that the recent Qualcomm-Apple settlement will bring forward 5G adoption and should propel demand for its Customer X's advanced nodes. In Singapore, we could see a pick-up in contributions from its sensor solutions customer, with the latter having secured new customers - Huawei and Xiaomi.

Sustainable O&G segment in the long run

Management explained that rising contribution from the O&G segment is due to more repair and maintenance (R&M) and coating works for old and new O&G equipment. This is as result of the increase in capex spending by oil majors. The Company has also seen increasing enquiries for its services and for longer-term contracts from its Customer P, which is still in the renegotiation process on pricing for each package. On top of this, the Company is targeting to secure new R&M works for 20 units of rotating equipment from Customer M.

FYE Dec (MYR m)	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue	297	327	390	441	483
EBITDA	65	92	117	136	157
Core net profit	36	53	69	83	96
Core EPS (sen)	3.4	5.1	6.6	7.9	9.1
Core EPS growth (%)	98.8	50.0	29.9	19.3	15.8
Net DPS (sen)	0.5	1.5	2.0	2.4	2.7
Core P/E (x)	13.6	13.8	20.0	16.7	14.4
P/BV (x)	1.7	2.3	3.7	3.2	2.8
Net dividend yield (%)	1.1	2.1	1.5	1.8	2.1
ROAE (%)	11.0	17.2	19.8	20.5	20.6
ROAA (%)	8.5	12.0	14.5	15.7	16.3
EV/EBITDA (x)	6.3	6.7	10.6	9.0	7.7
Net gearing (%) (incl perps)	net cash	net cash	net cash	net cash	net cash
Consensus net profit	-	-	67	77	86
MKE vs. Consensus (%)	-	-	2.9	8.1	12.0

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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)	1.40/0.41
3m avg turnover (USDm)	3.0
Free float (%)	47.6
Issued shares (m)	1,053
Market capitalisation	MYR1.4B
	USD335M

Major shareholders:

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

Price Performance

	-1M	-3M	-12M
Absolute (%)	15	52	230
Relative to index (%)	15	56	272

Source: FactSet

Valuation

We now value Frontken by ascribing to our FY20E EPS a higher PER of 23.5x (from 20x), which is +1.5 standard deviation above the company's average historical 1-year forward PER (previously +1.0 standard deviation above) (Fig. 5).

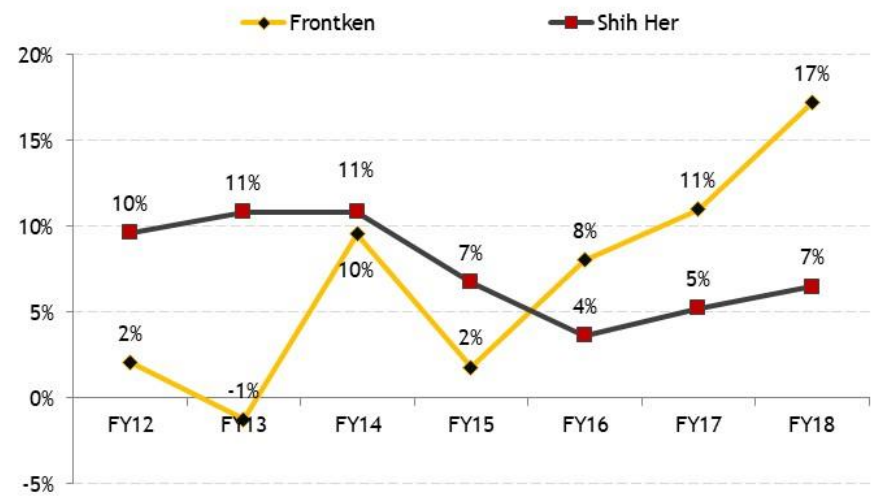
This is justified, in our view, given that we project a robust 2-year (2018-2020E) earnings CAGR of 24.5%, driven by improving fundamentals for both the global semiconductor and local O&G industries.

We forecast strong earnings growth of 29.9% in FY19E and 19.3% in FY20E. We also expect Frontken's ROE to trend higher to 20.5% by FY20E from 17.2% in FY18.

At our revised target price of MYR1.85 (MYR1.58 previously), the stock would trade at a PEG of just 0.96x. Our target price of MYR1.85 also implies a lower ex-net cash FY20E PER of 21.3x.

Since 80% of Frontken's revenue is derived from the semiconductor segment, of which 54% is contributed by its semiconductor segment in Taiwan, we think the most direct comparable peer is Shih Her Technologies (3551 TT; Not Rated). There are no consensus earnings forecasts for Shih Her Technologies, but Frontken's higher historical 2018 PER of 26.5x relative to Shih Her's 15.1x is justified in our view, given the former's superior ROEs (Fig. 1).

Fig 1: Frontken's and Shih Her Technologies' historical ROE



Source: Company data

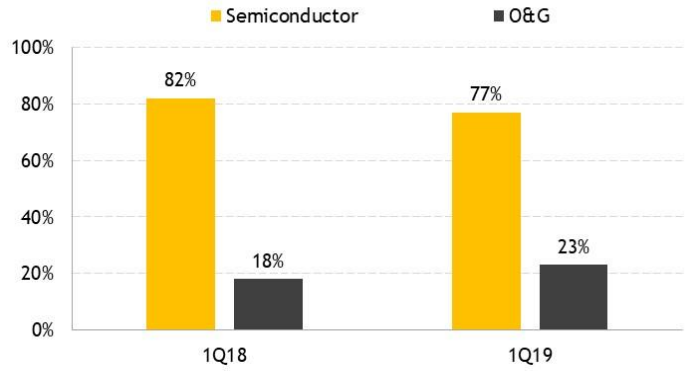
While there are no direct comparable peers in Malaysia with the same semiconductor operations as Frontken, we think its indirect comparable peer for its O&G segment in Malaysia is Serba Dinamik (SDH MK; Not Rated).

Fig 2: Peer comparison (as of 3rd May 2019)

Company	Blmbg code	Mkt Cap (USD m)	Rating	Price (LC)	TP (LC)	PER (x)			PBV (x)			ROE (%)		Yield (%)	
						CY18	CY19E	CY20E	CY18	CY19E	CY20E	CY18	CY19E	CY18	CY19E
Frontken	FRCB MK	342.1	BUY	1.35	1.85	13.8	20.4	17.1	2.3	3.8	3.3	17.2	19.8	1.1	1.5
Direct peer for its semiconductor segment in Taiwan															
Shih Her Tech	3551 TT	87.6	na	47.65	na	15.3	na	na	1.0	na	na	6.5	na	na	na
Indirect peer for its O&G segment in Malaysia															
Serba Dinamik	SDH MK	1,473.5	na	4.15	na	15.6	12.8	11.1	2.9	2.5	2.1	18.5	19.5	1.9	2.7

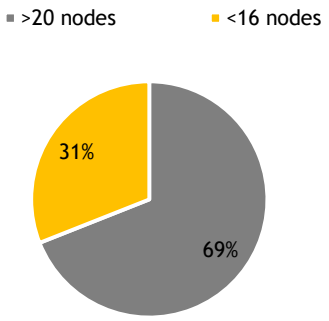
Source: Bloomberg, Company data, Maybank KE

Fig 3: 1Q19 revenue breakdown by segment



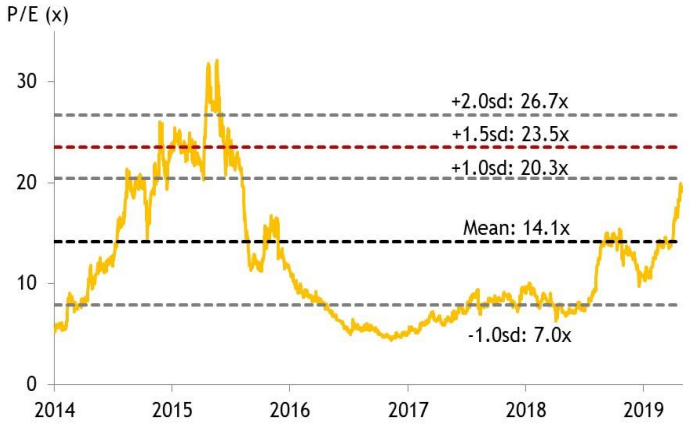
Source: Company data

Fig 4: 1Q19 semiconductor segment contribution by nodes



Source: Company data

Fig 5: 1-year forward PER



Source: Bloomberg, Company data, Maybank KE

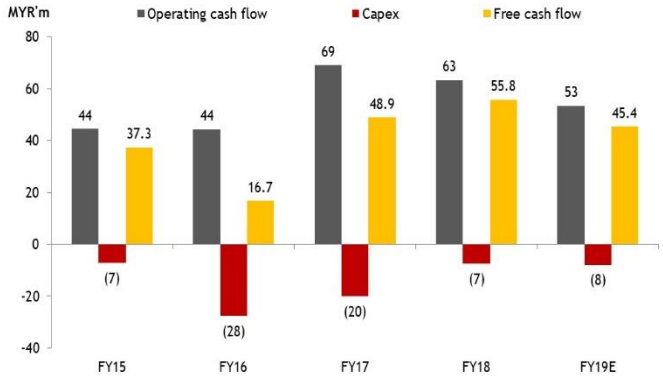
Fig 6: 1-year forward PBV

Source: Bloomberg, Company data, Maybank KE

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 advanced 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 in FY18 of MYR63.3m against net profit of MYR52.3m (depreciation MYR17.3m) and FCF of MYR55.8m.
- ROE has continued to improve from 4.3% in FY15 to 17.2% in FY18, through better profit margins.

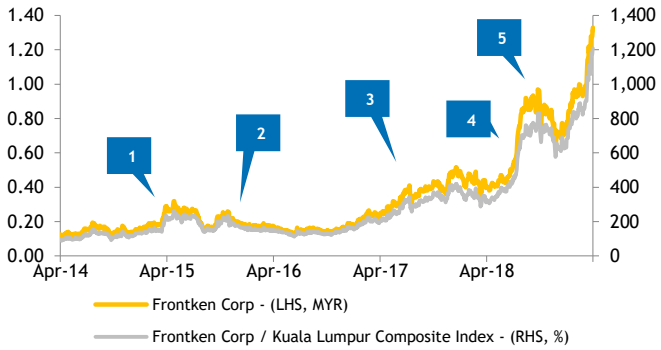
Sustainable FCF and OCF



Source: Company, Maybank KE

Price Drivers

Historical share price trend



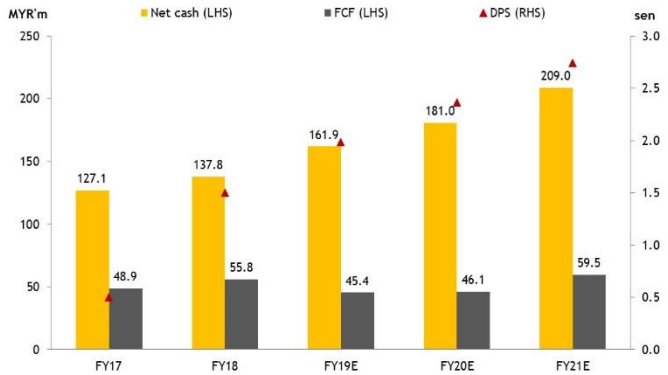
Source: Company, FactSet, Maybank Kim Eng

1. Achieved higher revenue from the semiconductor business in Taiwan and recognition of one-off EPCC project, which was the 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 higher core net profit of 99% YoY for Frontken.
4. CEO of Frontken, Ng Wai Pin emerged as the largest shareholder after an indirect acquisition of 27.77% was made via Dazzle Clean Ltd in Aug 2018.
5. Negative sentiment on 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 advanced chips and improving O&G industries outlook.
- Higher profit margins due to better services fees for handling complex equipment of advanced wafer fabrication process from 7nm and beyond.
- Net cash position (13sen/sh) in FY18 on low borrowings and strong cash flow.
- The Group paid higher dividend in FY18 of 1.5sen (vs. 0.5sen in FY17), equal to a 30.1% payout ratio. We forecast a 30% payout ahead, supported by strong FCF and an increasing net cash position in FY19E-21E.

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 work orders from new advanced technological nodes.
- 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 lead to lower O&G sector demand for services.

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FYE 31 Dec	FY17A	FY18A	FY19E	FY20E	FY21E
Key Metrics					
P/E (reported) (x)	11.1	12.0	20.0	16.7	14.4
Core P/E (x)	13.6	13.8	20.0	16.7	14.4
P/BV (x)	1.7	2.3	3.7	3.2	2.8
P/NTA (x)	1.7	2.3	4.4	3.7	3.2
Net dividend yield (%)	1.1	2.1	1.5	1.8	2.1
FCF yield (%)	10.1	7.6	3.3	3.3	4.3
EV/EBITDA (x)	6.3	6.7	10.6	9.0	7.7
EV/EBIT (x)	8.8	8.3	12.4	10.3	8.7
INCOME STATEMENT (MYR m)					
Revenue	296.6	327.2	390.3	441.2	483.1
Gross profit	104.8	126.6	160.1	182.5	205.8
EBITDA	64.8	92.5	117.4	136.2	156.5
Depreciation	(18.5)	(17.3)	(16.7)	(17.0)	(17.5)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	46.3	75.2	100.7	119.1	139.0
Net interest income /(exp)	(0.1)	0.3	0.1	0.1	0.2
Associates & JV	(0.1)	0.1	0.0	0.0	0.0
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	46.1	75.6	100.8	119.3	139.2
Income tax	(9.7)	(18.6)	(25.1)	(28.6)	(33.4)
Minorities	(6.6)	(4.7)	(6.3)	(8.0)	(10.1)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	29.9	52.3	69.3	82.7	95.8
Core net profit	35.6	53.4	69.3	82.7	95.8
BALANCE SHEET (MYR m)					
Cash & Short Term Investments	129.3	149.9	174.0	193.1	221.1
Accounts receivable	97.0	113.6	147.2	185.3	229.2
Inventory	13.5	13.7	14.3	18.5	23.1
Reinsurance assets	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equip (net)	150.0	140.4	127.5	118.5	109.0
Intangible assets	33.8	33.8	33.8	33.8	33.8
Investment in Associates & JVs	2.0	0.0	0.0	0.0	0.0
Other assets	5.5	3.7	3.7	3.7	3.7
Total assets	**431.1**	**455.1**	**500.5**	**552.8**	**619.9**
ST interest bearing debt	16.9	4.8	2.7	2.7	2.7
Accounts payable	79.6	81.6	76.9	65.7	58.7
Insurance contract liabilities	0.0	0.0	0.0	0.0	0.0
LT interest bearing debt	11.7	8.9	8.1	8.1	8.1
Other liabilities	17.0	15.0	15.0	15.0	15.0
Total Liabilities	**125.1**	**110.4**	**103.0**	**91.8**	**84.8**
Shareholders Equity	281.6	325.0	373.6	431.4	498.5
Minority Interest	24.4	19.6	24.0	29.6	36.6
Total shareholder equity	**306.0**	**344.6**	**397.6**	**461.0**	**535.1**
Total liabilities and equity	**431.1**	**455.1**	**500.5**	**552.8**	**619.9**
CASH FLOW (MYR m)					
Pretax profit	46.1	75.6	100.8	119.3	139.2
Depreciation & amortisation	18.5	17.3	16.7	17.0	17.5
Adj net interest (income)/exp	0.1	(0.3)	(0.1)	(0.1)	(0.2)
Change in working capital	6.9	(15.9)	(38.9)	(53.5)	(55.6)
Cash taxes paid	(7.9)	(14.2)	(25.1)	(28.6)	(33.4)
Other operating cash flow	5.4	(0.4)	0.0	0.0	0.0
Cash flow from operations	69.0	63.3	53.4	54.1	67.5
Capex	(20.2)	(7.5)	(8.0)	(8.0)	(8.0)
Free cash flow	48.9	55.8	45.4	46.1	59.5
Dividends paid	(7.2)	(10.0)	(22.7)	(27.2)	(31.7)
Equity raised / (purchased)	0.0	0.0	0.0	0.0	0.0
Change in Debt	(0.2)	(17.3)	(1.9)	0.0	0.0
Other invest/financing cash flow	(12.9)	(0.2)	0.1	0.1	0.2
Effect of exch rate changes	(6.4)	0.3	0.1	0.0	0.0
Net cash flow	22.2	28.7	21.0	19.0	28.0

FYE 31 Dec	FY17A	FY18A	FY19E	FY20E	FY21E
Key Ratios					
Growth ratios (%)					
Revenue growth	13.3	10.3	19.3	13.0	9.5
EBITDA growth	26.9	42.8	26.9	16.0	14.9
EBIT growth	36.8	62.4	33.9	18.3	16.7
Pretax growth	38.4	63.9	33.2	18.4	16.7
Reported net profit growth	49.0	75.0	32.7	19.3	15.8
Core net profit growth	98.8	50.0	29.9	19.3	15.8
Profitability ratios (%)					
EBITDA margin	21.8	28.3	30.1	30.9	32.4
EBIT margin	15.6	23.0	25.8	27.0	28.8
Pretax profit margin	15.6	23.1	25.8	27.0	28.8
Payout ratio	17.5	30.1	30.0	30.0	30.0
DuPont analysis					
Net profit margin (%)	10.1	16.0	17.8	18.7	19.8
Revenue/Assets (x)	0.7	0.7	0.8	0.8	0.8
Assets/Equity (x)	1.5	1.4	1.3	1.3	1.2
ROAE (%)	11.0	17.2	19.8	20.5	20.6
ROAA (%)	8.5	12.0	14.5	15.7	16.3
Liquidity & Efficiency					
Cash conversion cycle	(0.3)	(4.4)	18.2	59.2	100.7
Days receivable outstanding	120.3	115.8	120.3	135.7	154.5
Days inventory outstanding	23.0	24.4	21.9	22.8	27.0
Days payables outstanding	143.5	144.6	123.9	99.2	80.8
Dividend cover (x)	5.7	3.3	3.3	3.3	3.3
Current ratio (x)	2.2	2.8	3.7	5.0	6.5
Leverage & Expense Analysis					
Asset/Liability (x)	3.4	4.1	4.9	6.0	7.3
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)	nm	na	na	na	na
Debt/EBITDA (x)	0.4	0.1	0.1	0.1	0.1
Capex/revenue (%)	6.8	2.3	2.0	1.8	1.7
Net debt/ (net cash)	(100.7)	(136.3)	(163.2)	(182.2)	(210.2)

Source: Company; Maybank

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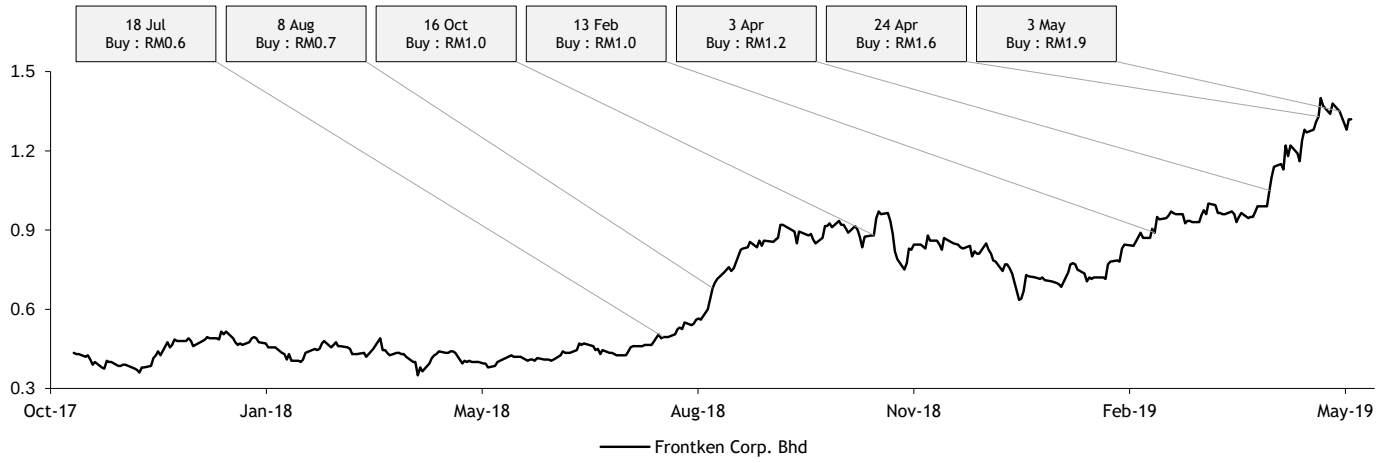

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