Shariah Compliant

Industrials

Malaysia

July 18, 2018

Maybank IB Research

# Frontken Corp. Bhd (FRCB MK)

# Coating the growth

# BUY

| | |
|---|---|
| Share Price | MYR 0.50 |
| 12m Price Target | MYR 0.63 (+27%) |

## Initiate BUY, TP MYR0.63

Frontken provides cleaning and coating services, offering cost effective solutions to various industries. We estimate earnings to grow at a healthy 14.7% 3-year CAGR (FY17-20E) driven by the rapid development of the semiconductor market. The stock is attractively valued, trading at a 2019E PER of 11.9x, 29% below the indirect local peer average of 16.8x. Ex-cash (net cash of 9sen/shr), PERs are even lower at just 7.0x for FY19. We initiate at BUY with TP of MYR0.63 based on a FY19 PER of 15x, 0.5 SD above the mean due to its robust earnings CAGR.

## A leading provider of cleaning and coating services

Founded in 1996, Frontken has continuously developed and refined its capabilities of coating and precision cleaning services of high-tech equipment for various industries. Today, the Group stands as a leading service provider for logic foundry and memory semiconductors process equipment, which it has more than a 90% market share in Malaysia and is the second largest in Taiwan based on revenue. Its services to the O&G market contribute 15% of Group revenue but <10% of group profit.

## Earnings growth fuelled by semiconductors market

We think demand for Frontken's services will be driven by an increasing number of orders for its services, especially from new capacity expansion at its key customers and memory-DRAM players. Meanwhile, the push up the value chain from its key customers does imply that Frontken will continue to be busy providing services with improved profit margin driven, by higher fees for servicing complex high technological process equipment.

## Net cash position and strong cash flow

The Group is in net cash position reflecting strong cash flow generation due to low borrowings and good working capital management. As at end-Mar 2018, its net cash position and borrowings stood at MYR95.2m (9sen/sh) and MYR26.8m, respectively. FCF last year was strong with positive yield of 10.9% and we forecast 12-15% going forward. This should help support future growth and rising dividend payments.

| FYE Dec (MYR m) | FY16A | FY17A | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Revenue | 262 | 297 | 323 | 365 | 410 |
| EBITDA | 51 | 65 | 74 | 84 | 96 |
| Core net profit | 18 | 34 | 37 | 44 | 52 |
| Core EPS (sen) | 1.7 | 3.3 | 3.5 | 4.2 | 5.0 |
| Core EPS growth (%) | 202.2 | 92.7 | 6.8 | 18.8 | 18.8 |
| Net DPS (sen) | 0.0 | 0.5 | 0.7 | 0.8 | 1.0 |
| Core P/E (x) | 9.2 | 9.6 | 14.1 | 11.9 | 10.0 |
| P/BV (x) | 0.6 | 1.2 | 1.7 | 1.5 | 1.3 |
| Net dividend yield (%) | 0.0 | 1.6 | 1.4 | 1.7 | 2.0 |
| ROAE (%) | 8.0 | 11.0 | 12.4 | 13.3 | 14.2 |
| ROAA (%) | 4.5 | 8.2 | 8.3 | 9.0 | 9.7 |
| EV/EBITDA (x) | 2.7 | 6.3 | 5.4 | 4.3 | 3.3 |
| Net gearing (%) (incl perps) | net cash | net cash | net cash | net cash | net cash |
| Consensus net profit | - | - | 42 | na | na |
| MKE vs. Consensus (%) | - | - | (12.4) | na | na |

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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.*

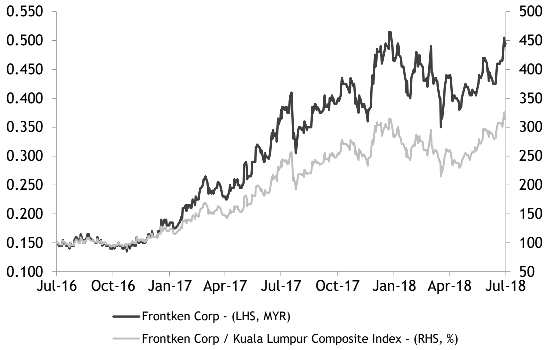
### Statistics

| | |
|---|---|
| 52w high/low (MYR) | 0.52/0.31 |
| 3m avg turnover (USDm) | 0.5 |
| Free float (%) | 47.6 |
| Issued shares (m) | 1,053 |
| Market capitalisation | MYR484.6M |
| | USD120M |

Major shareholders:

| | |
|---|---|
| CP Asia Holding GmbH | 27.8% |
| OOI KENG THYE /FRONTKEN/ | 14.5% |
| CIMB-Principal Asset Management Bhd. | 4.8% |

### Price Performance



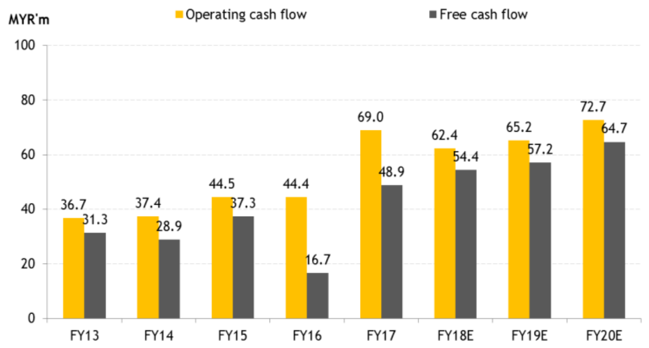

| | -1M | -3M | -12M |
|---|---|---|---|
| Absolute (%) | 8 | 13 | 30 |
| Relative to index (%) | 8 | 22 | 32 |

*Source: FactSet*

# 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.

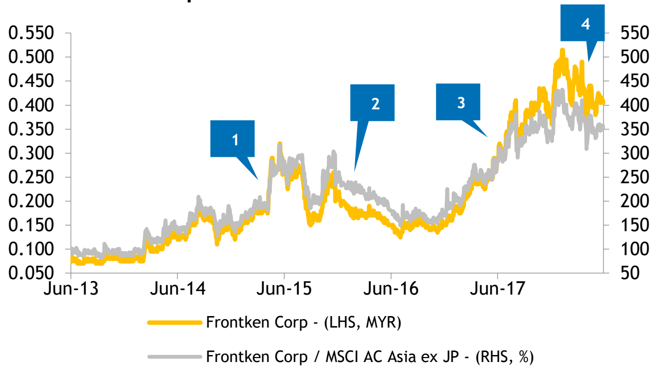
### Sustainable FCF and OCF




*Source: Company, Maybank KE*

# Price Drivers

### Historical share price trend



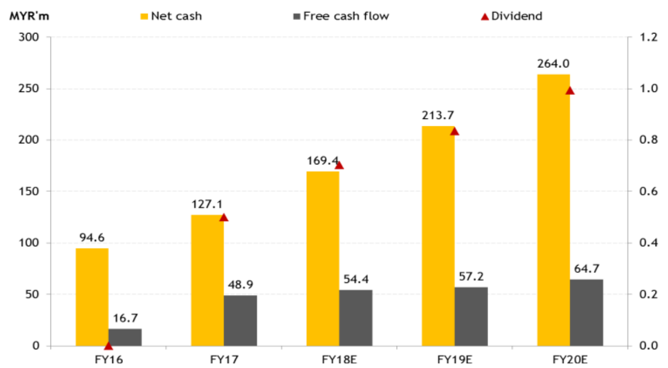

*Source: Company, FactSet, Maybank Kim Eng*

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 growth to slow in FY18E to 9% from 13% in FY17 but to pick up in FY19/20E on increasing demand for chips.
- Higher profit margins due to better services fees for handling complex process of advance wafer fabrication process (nodes).
- Net cash position (9sen/sh) 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 lead to lower O&G sector demand for services.

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# Investment thesis

## A leading provider of cleaning and coating services

Frontken today is a leading service provider of surface engineering treatment and precision cleaning for components of leading edge semiconductor equipment in Malaysia and Taiwan. It has more than a 90% market share in Malaysia and it is the second largest in Taiwan based on revenue. Its services also cover the O&G market, which contributes about 15% of the Group's revenue but is less than 10% at the profit level. The Group is led by the same senior management working with the Group since its listing in 2006, and who have extensive experience and in-depth knowledge in the semiconductor field and advance materials engineering.

## A unique way for investors to gain semiconductor exposure

Being a niche player in providing cleaning and coating services to logic foundry and memory semiconductor companies in the upstream part of the value chain, Frontken offers investors different exposure to a valuable part of the semiconductor market. We expect its earnings growth to be driven by higher top line growth from increasing orders for its services, especially from logic foundry and DRAM players' capacity expansion and high-end technological process. We also expect Frontken's earnings growth to be supported by better services fees for handling complex equipment, which should lead to higher profit margins.

## Semiconductor industry can further develop

As most of its revenue comes from the semiconductor market, Frontken stands to benefit from the further growth of and positive development in the advanced wafer fabrication process of both logic foundry and memory semiconductors. The industry growth will be driven by existing and potential mass production of advance technology nodes from growing global demand for high-performance and power efficient chips at end-use markets, particularly smartphones and data centres. This will lead to high utilisation rates for wafer fabrication equipment for which Frontken provides cleaning services. The higher the utilisation rate and more equipment used, the higher number of service orders Frontken will receive.

## Initiate BUY with MYR0.63 TP

We initiate coverage of Frontken with a BUY rating and TP of MYR0.63. Our TP is based on a target FY19 PER of 15x, which is 0.5 standard deviations above its 3-year historical average of 12x. This translates to a FY19 P/NTA of 1.5x and a FY19E PER excluding net cash of 7.0x, which we think is reasonable given that we estimate a robust 3-year earnings CAGR of 14.7% in FY17-20E.

While there are no direct comparable peers in Malaysia with the same operations as Frontken; these companies follow the global semiconductor cycle. As such, we think that our target PER of 15x is reasonable vs. local semiconductor players whose weighted average FY19 PER is 16.8x.

In Taiwan, its closest competitor is Shih Her Technologies Inc. (3551 TT MK). There are no consensus earnings forecasts for Shih Her but historically, Frontken has traded at a lower 3-year average PER of 12x vs. Shih Her's 16.6x, despite Frontken's superior profitability. We believe the historical discount is due to Shih Her's historical superior profit margin and ROE, which should change now as Frontken's profitability levels have surpassed Shih Her's ROE

## Risks

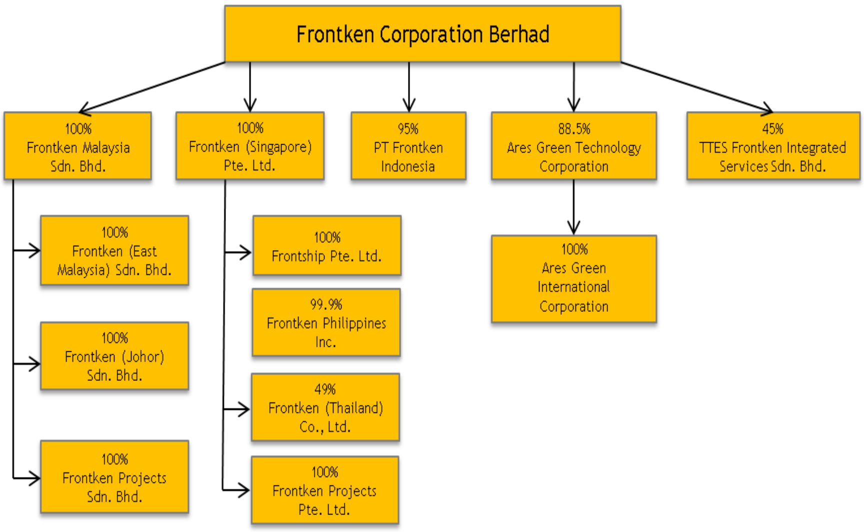
Key risks include: (i) an economic slowdown, particularly in its most important market (Taiwan) and industry (semiconductors), which adversely impacts consumer sentiment, leading to a falloff in investment; (ii) reliance on the semiconductor industry, which is cyclical; (iii) new semiconductor technological processes may squeeze profit margins across the value chain; (iv) uncertainty in oil price trends; (v) foreign exchange risk; and (vi) disruptions to operations due to equipment problems.

# Corporate Information

## A leading provider of critical surface engineering

Founded in 1996, Frontken is a leading service provider of surface engineering treatment and precision cleaning for components of leading edge equipment used in various application markets, particularly for semiconductor and O&G, mainly for the Taiwan, Singapore and Malaysia markets (Fig. 1). With respect to the semiconductor segment, the Group has more than a 90% market share in Malaysia and it is the second largest in Taiwan based on revenue.

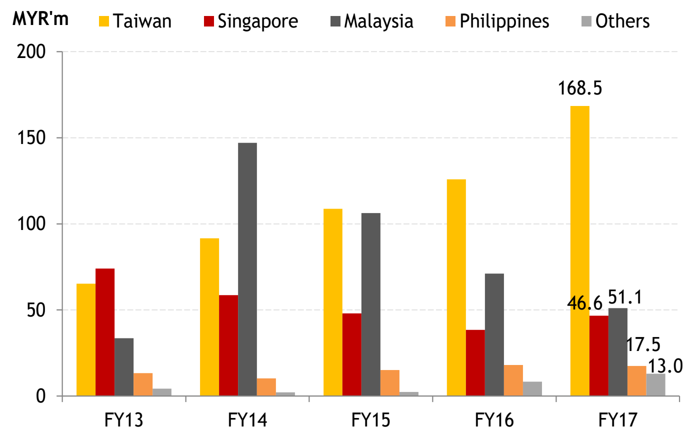
**Fig 1: Corporate structure**




*Source: Company data*

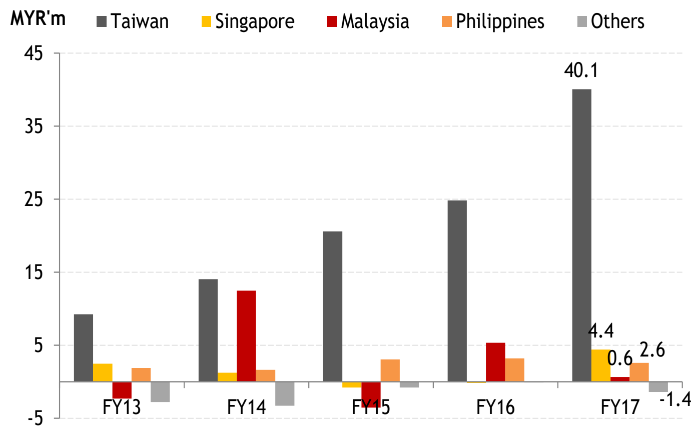
About 56.8% of revenue in FY17 was from Taiwan, with the other markets being Singapore (15.7%), Malaysia (17.2%), Philippines (5.9%) and others (4.4%) (Fig. 2). Taiwan contributed to more than 80% of the Group's EBIT in FY17 (Fig. 3). Over the last five years (from FY13 to FY17), the revenue and EBIT contributions from its Taiwan segment have been growing at a rapid CAGR of 27.5% and 77.2% respectively, driven by increasing semiconductor business.

**Fig 2: 5-year revenue trend by geography**




*Source: Company data*

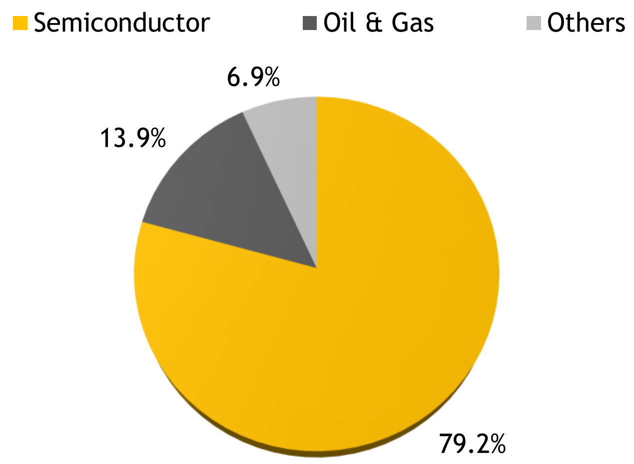
**Fig 3: 5-year geographical EBIT trend**




*Source: Company data*

The Group has a diverse customer base of more than 70 customers, comprising multinational corporations, and small- and medium-sized enterprises in various application markets. By application markets, the semiconductor market contributed the largest portion (79.2%) to Group revenue in FY17 (Fig. 4).

**Fig 4: Revenue breakdown by application markets**




*Source: Company data*

The Group operates its 15 facilities within the countries listed in Fig. 5, with headquarters in Kuala Lumpur, Malaysia. Frontken also has an operation in Thailand via a 49%-owned associate, mainly involved in thermal spray coating processes and a series of complementary processes, including mechanical and chemical engineering works.

The revenue is essentially generated from the number (volume) of orders and components of leading edge equipment, which increase with the demand for its services. As the services are mostly of a customised nature and involve many SKUs, the Group does not have a routine services schedule and operates its plants on a 24-hour shift. Therefore, it is impractical to estimate the production capacity and utilisation of its operating facilities. However, the Group reaffirms that it does not face any constraint on its production capacities at this juncture.

**Fig 5: The Group's facilities in Asia Pacific**


*Source: Company data*

## Precision cleaning of manufacturing equipment parts

Frontken's business activities are focused on precision cleaning services to the primary and predominantly in the secondary markets. Its services involve cleaning substrate surfaces in the components of leading-edge equipment for numerous application markets, in particular wafer fabrication and others such as storage media, flat panel displays, hard disk drives and organic light-emitting diodes.

The components require the most stringent cleanliness to very exacting standards, with very low tolerance for left-over microscopic (<0.3 microns) particles or other contaminants, so as to increase efficiency and extend the lifespan of the equipment.

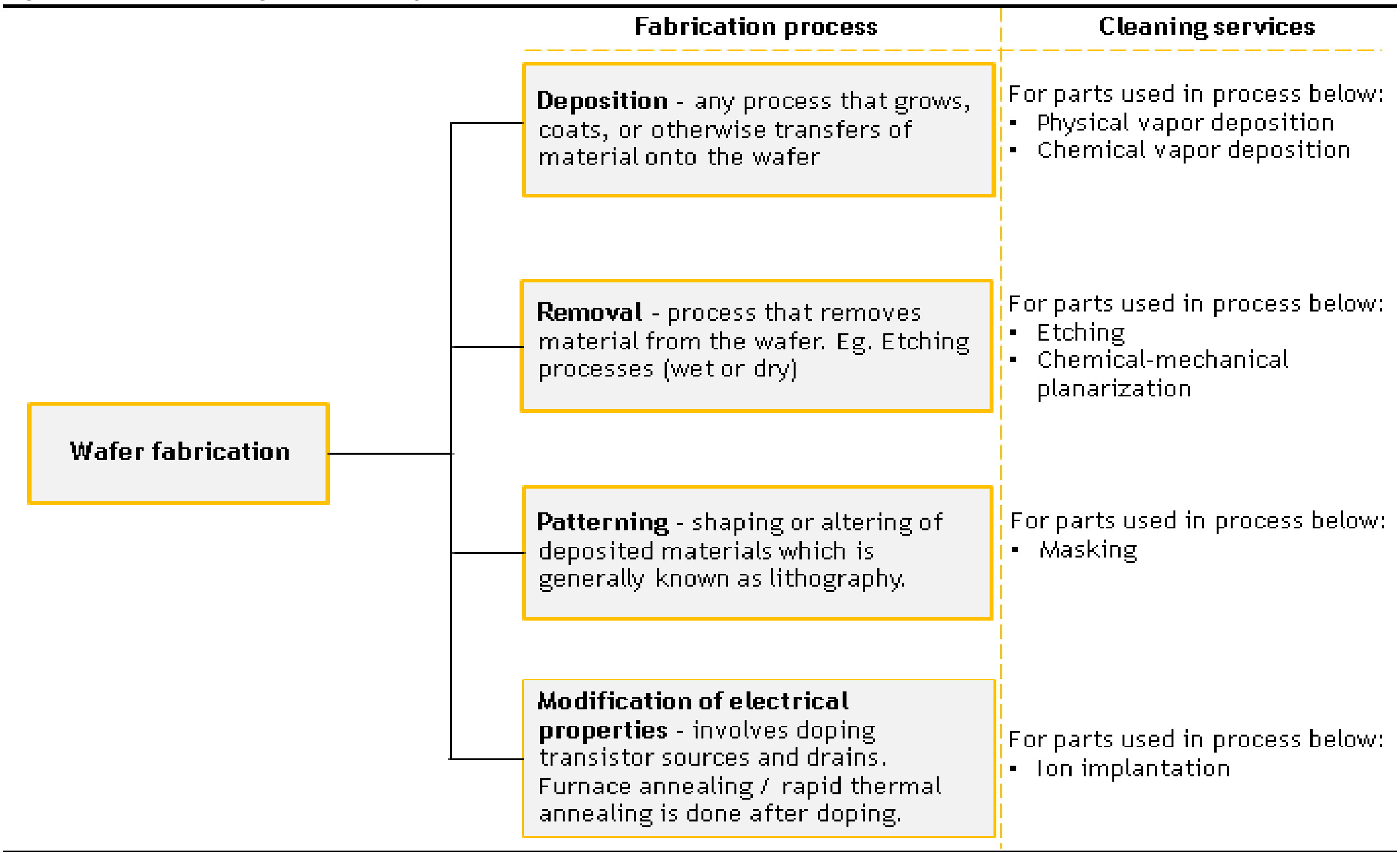
Its primary market is in the cleaning of critical newly fabricated components of semiconductor equipment prior to assembly, and the Group works closely with OEMs. In the secondary market, the Group regularly cleans equipment components that have been contaminated during the fabrication process, and cleans damaged components prior to and after repair.

## Competitive edge for precision cleaning

Over the last two years, the Group has spent approximately MYR40m on new high-precision cleaning technology and the renovation of its existing Taiwan facility, which will allow operations to service increasingly complex components of sophisticated semiconductor equipment in wafer fabrication.

Put simply, fabrication is a process that converts wafers into integrated circuit and memory chips from physical vapour deposition, to etching, diffusion and related processes (Fig. 6). This new technology will cater to its customers' new wafer fabrication process node (fabricating chips according to the most cutting-edge process) up to 5-nanometer (nm).

**Fig 6: Precision cleaning services to upstream semiconductor fabrication**




*Source: Company data*

The Group will also benefit from its alliance with OEMs, specifically Lam Research, whereby it will provide cleaning, repair and restoration services to the latter's customers. Lam Research is one of the leading suppliers of wafer fabrication equipment and services to the global semiconductor industry. The alliance also presents opportunities for the sharing of technology and involvement in joint R&D projects.

Frontken itself has strong in-house R&D capabilities to provide a comprehensive scope of work in meeting the specific needs of its customers, which is paramount in delivering reliable and quality services. The Group's main R&D focus is in developing new innovative processes and materials for application markets undergoing strong expansion.

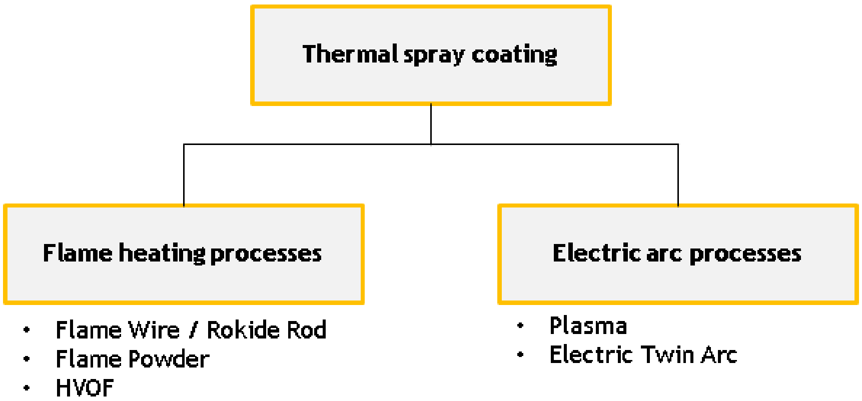
As a service-based solutions provider with R&D activities, its expertise lies in its ability to identify ways to provide innovative solutions to improve its customers' production process.

## Comprehensive range of thermal spray coating

Frontken also provides a full range of thermal spray coating onto the surfaces of equipment, a service that has been the foundation of the Group's business since inception. The company develops cost effective solutions for customers to help combat high temperature corrosion of equipment. This involves customising surface treatments to meet customer specifications, developing new coating solutions, and providing consultancy services.

Its coating business provides coating solutions for the O&G petrochemical equipment, semiconductors, and power generation markets. The coating process is executed via a robotic aided coating system. There are several types of thermal spray coating process employed by the Group, as summarized in Fig. 7.

**Fig 7: Process capabilities**




*Source: Company data*

## Major shareholders and senior management team

Frontken is currently steered by Ng Wai Pin, who was re-designated to Group's Chairman/CEO in 2018 from Group Chairman/Managing Director in 2012. Prior to that, he was senior independent non-executive director, a role he held since 2006. As at 20th March 2018, Ng Wai Pin holds a 0.63% direct stake in Frontken.

Ng Wai Pin is assisted by his long-time fellow executive director, Dr Tay Kiang Meng and management team (Appendix), who have extensive working experience in the semiconductor field and advance materials engineering. He is also the Chairman of Ares Green Technology Corporation, a subsidiary of Frontken in Taiwan.

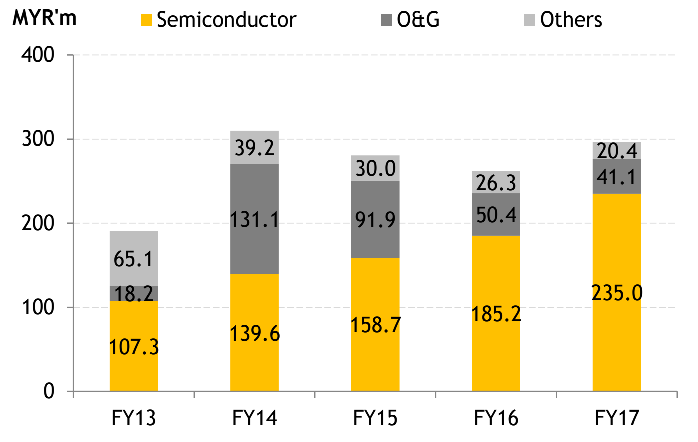
Frontken's major shareholder is CP Asia Holding GmbH with an effective 27.8% stake. We understand that Dr Jorg Helmut Hohnloser, Frontken's Independent Non-Executive Director is the major shareholder of CP Asia. He first bought into Frontken back in 2010 via CP Asia, and increased his stake up to its present 27.8%.

# Investment Focus

## Growth drivers

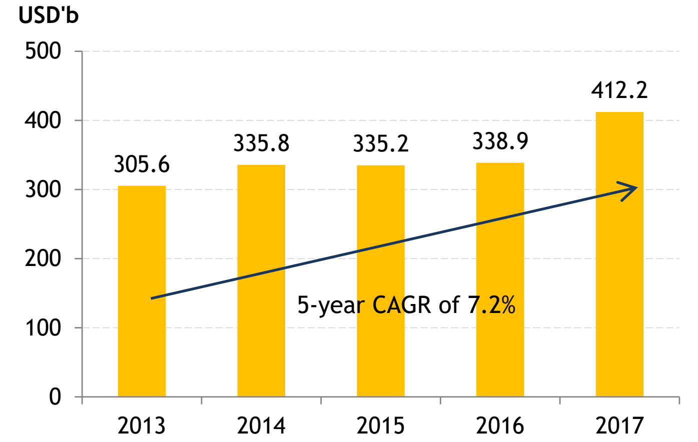
Frontken's growth is anchored by customers in both logic and memory semiconductor markets. These markets account for more than two-thirds of Group revenue, which grew at a 5-year CAGR of 21% (FY12-FY17) to MYR235.0m (Fig. 8). This was attributed to strong demand for its services as the industry grew. The industry achieved a 5-year CAGR of semiconductor sales revenue worldwide of 7.2% (Fig 9).

**Fig 8: Frontken's 5-year segmental revenue**




*Source: Company data*

**Fig 9: Semiconductor industry sales worldwide**

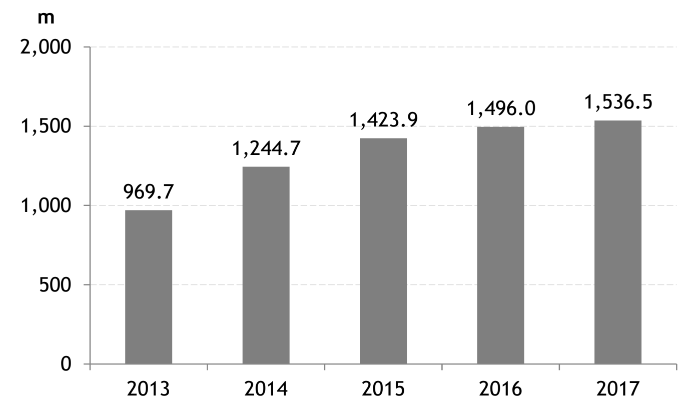



*Source: Statista*

The inflection point came in FY13 when smartphones became increasingly portable and product demand significantly increased. As foundries ramped up fabrication (production) to cater to the increasing demand for chips for high-end electronic products such as tablets and smartphones, the utilisation rate of equipment increased to high levels. In turn, foundry players have turned to Frontken to provide cleaning and coating services for their existing and new equipment in order to maintain performance, reliability and yield.

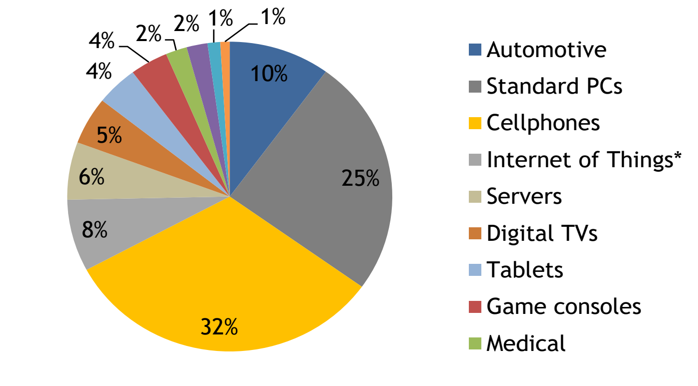
Global smartphone sales grew at a 5-year CAGR of 17.7% (FY12-FY17; Fig. 10) and still represent the biggest chip market at 32% of total global industry sales last year (Fig. 11).

**Fig 10: Global smartphone sales to end users**




*Source: Statista*

**Fig 11: End-use market for chips, based on revenue worldwide in 2017**

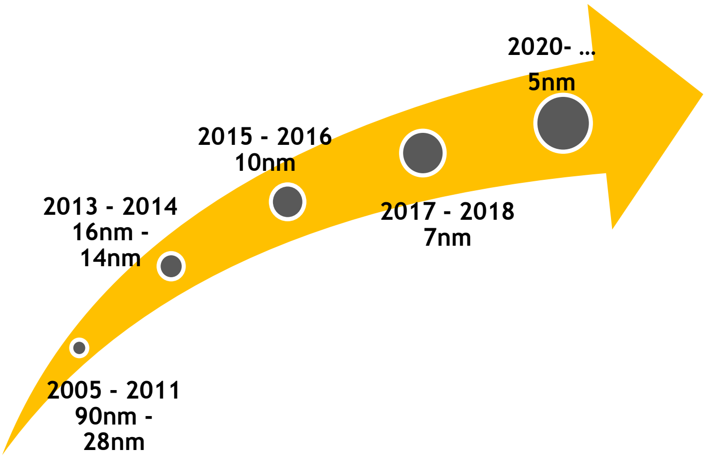



*Source: Statista*

Frontken also benefits from the increasing complexity of new equipment components that it services. The driver for this is the shrinking and increasingly more complex technology node, which requires that the new equipment that foundries use to also become more sophisticated. Pursuant to that trend, the Group prices its services slightly higher for handling more sophisticated equipment.

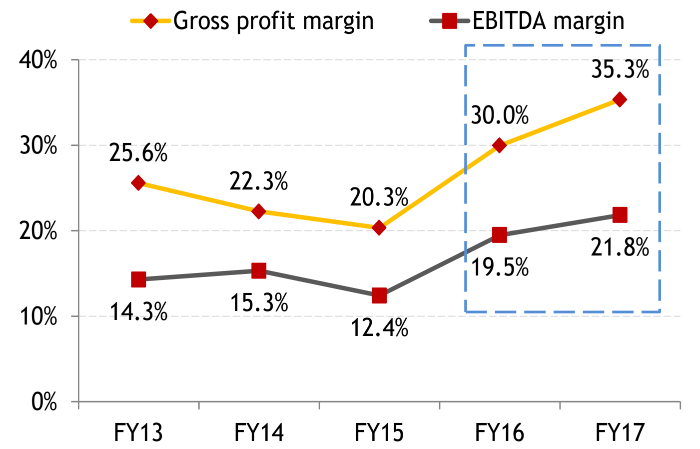
During the last two years, the industry has progressed to the 10nm and 7nm nodes (Fig. 12). The advancement of process nodes essentially is to make electronic devices smaller and more power optimized. This evolution has partly contributed to the Group's profit margin expansion during FY16 and FY17 due to the services provided for sophisticated equipment (Fig. 13). Prior to this period (FY13-FY15), we opine that the company was providing services for customers' process nodes of >28nm, which drove strong profit growth but not higher profit margins. However, the decline in profit margins in FY15 resulted from cost overruns and losses in its O&G segment.

**Fig 12: Industry's technology nodes roadmap in recent years**




*Source: Various*

**Fig 13: Frontken's 5-year profit margin trend**

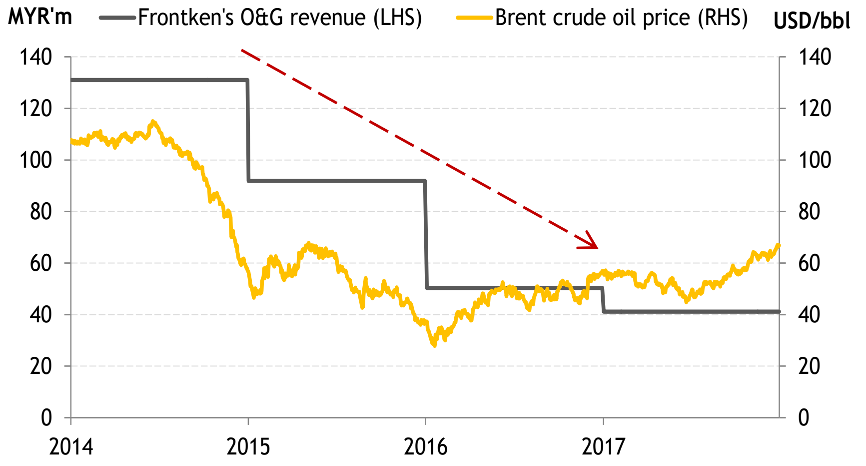



*Source: Company data*

Another potential source of earnings growth is the O&G related market, which currently accounts for 13.9% of Group revenue but less than 5% of Group EBIT in FY17. Its thermal coating service is used primarily to resist wear in rotating components, such as valves, pumps and compressors. It is also a prerequisite for new static equipment installations, such as piping, heat exchangers, spool system, storage tanks and pressure vessels.

It helps to improve in-service performance of equipment and life extension capabilities, which reduce operating and maintaining equipment costs. In the last three years, the contribution to the bottom line has contracted, which we think resulted from the lower O&G related activities due to the oil prices retrenchment (Fig. 14) and a resultant shift in focus to the semiconductor market.

**Fig 14: The Group's O&G revenue vs. Brent crude oil price**




*Source: Company data, Bloomberg*

## Key customer profile

The bulk of the Group's revenue is contributed by its customers in Taiwan, mostly those in the upstream semiconductor value chain. One of these customers made up 49% and 28% of its Taiwan and Group revenue in FY17, respectively. Revenue contribution from this customer has grown strongly at a 3-year CAGR (FY14-FY17) of 61% to MYR83m.

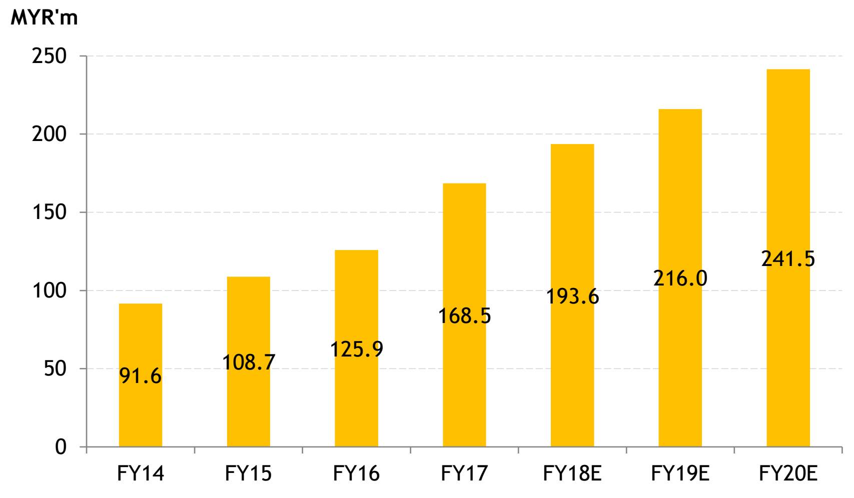
We understand that Frontken's key customer (Customer X) is one of the world's leading semiconductor foundry suppliers, whose wafer capacity growth rate is projected to be in the high single-digit range over the next two years, much of which will be focused on the higher node technology range of 7nm.

Therefore, we expect Customer X's additional capacity and higher node technology to benefit Frontken as it will continue to be busy with more cleaning services with better margins when the 7nm node starts mass production this year. We also opine that Customer X's combined existing and expected new fabrication capacity utilisation rate of more than 90% will translate to sustainable orders for Frontken's services.

We expect the production of smaller chip nodes to gain momentum when the migration for the smaller sizes picks up over the coming years driven by power and efficiency gains for electronic devices.

We expect revenue contribution from Customer X to grow at a double digit rate for the next three years. Meanwhile, we assume its other customers in Taiwan will contribute low teens growth during that period (Fig. 15). We opine its other customers' contribution will be coming from upstream semiconductors, particularly foundries and memory-DRAM manufacturers, and solar manufacturing equipment parts.

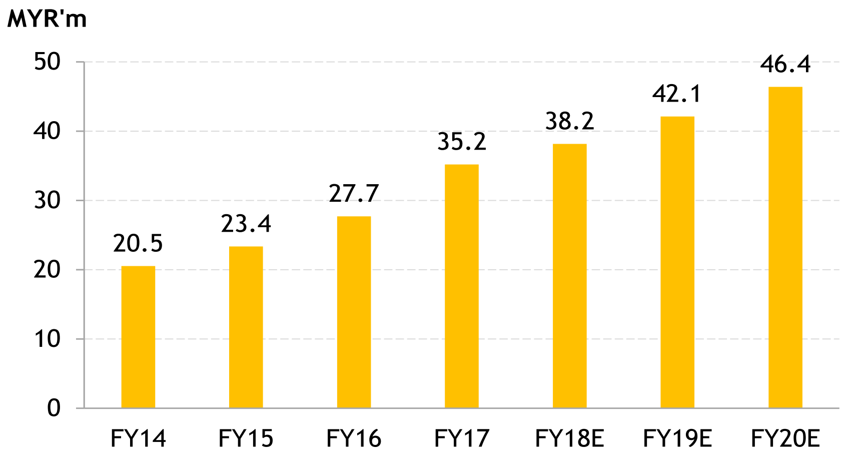
**Fig 15: Revenue contribution from Frontken's customers in Taiwan**




*Source: Company data, Maybank KE*

We note that its semiconductor customers in Singapore (mostly in upstream) also contribute a significant portion of its revenue, equal to 15% and 11.9% of its semiconductor segment and Group revenue last year. We see on-going industry development and the ramp up of fabrication, technology nodes and building new fabs in Singapore to continue driving the Group's cleaning services. Additionally, we understand its new customer has yet to start production. Hence, we expect revenue growth from the semiconductor segment in Singapore to remain strong for the next three years (Fig. 16).

**Fig 16: Revenue contribution from Frontken's customers in Singapore**




*Source: Company data, Maybank KE*

# Industry Analysis

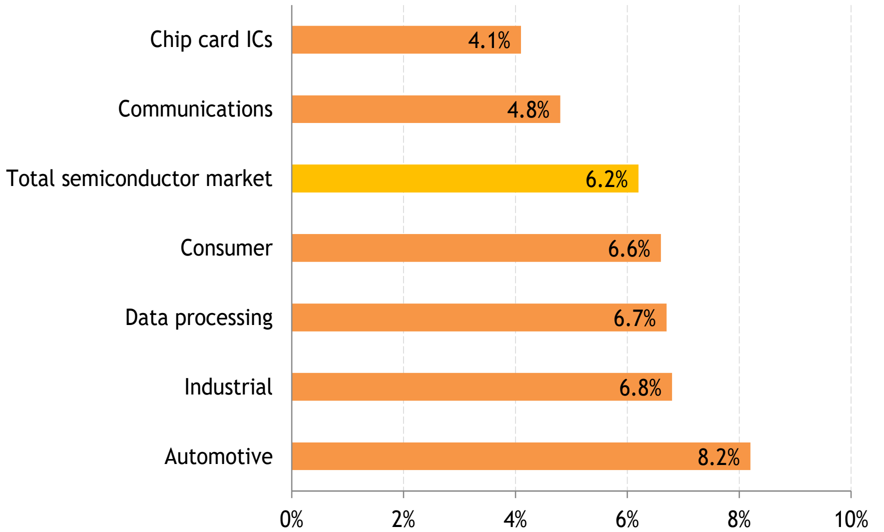
## Semiconductor market to remain in LT growth phase

The outlook for Frontken's precision cleaning services is tied to the development of both logic foundry and memory semiconductors. Demand for its services will be driven by existing and new capacity and potential mass production of advanced technology nodes from growing global demand for high-performance computing, electronics, and smartphones, artificial intelligence, automotive, data centre and even cryptocurrency.

Additionally, we think it could cost more than USD100m for both logic foundry and memory semiconductor players to buy/replace some critical wafer equipment. Therefore, Frontken offers precision cleanings services as the best alternative for foundries to save costs through the maintenance and extension of the shelf life of critical equipment. We see Frontken providing cleaning services as a long-term positive to support future sustained growth.

Based on *Statita's* forecast, the semiconductor market is forecast to grow at a 6.2% CAGR (2016-21) driven by the markets as depicted in Fig. 17. We think these markets will drive demand for chips in the next five years but the smartphone will still comprise the largest portion for the foundries in the near term.

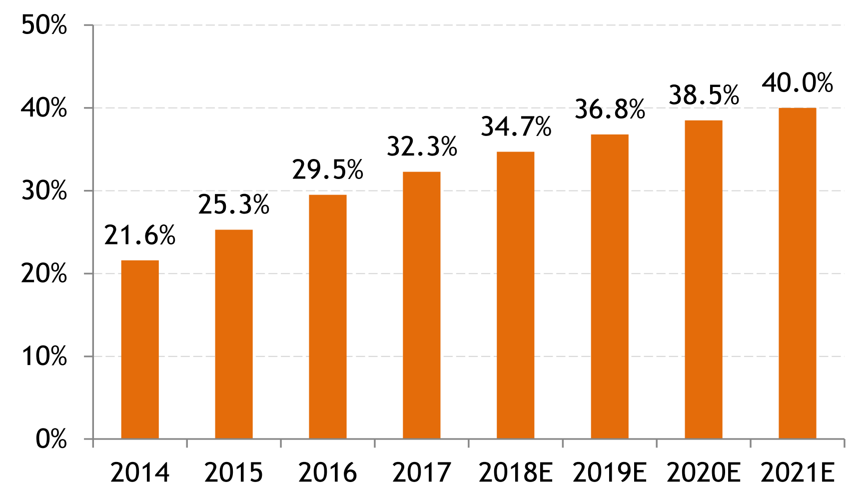
**Fig 17: Breakdown of target markets accounting for 5-year CAGR (2016-2021)**




*Source: Statista*

Having said above, we have factored into our forecasts potential downside risk of premium smartphone demand. Although the growth rate for smartphone unit sales has slowed from 42.5% in 2013 to 2.7% last year (as depicted in Fig. 10), we believe demand for smartphones remains sustainable given that the global smartphone user penetration rate was only 32.3% in 2017, and is expected to reach 40% by 2021, according to *Statista* (Fig. 18).

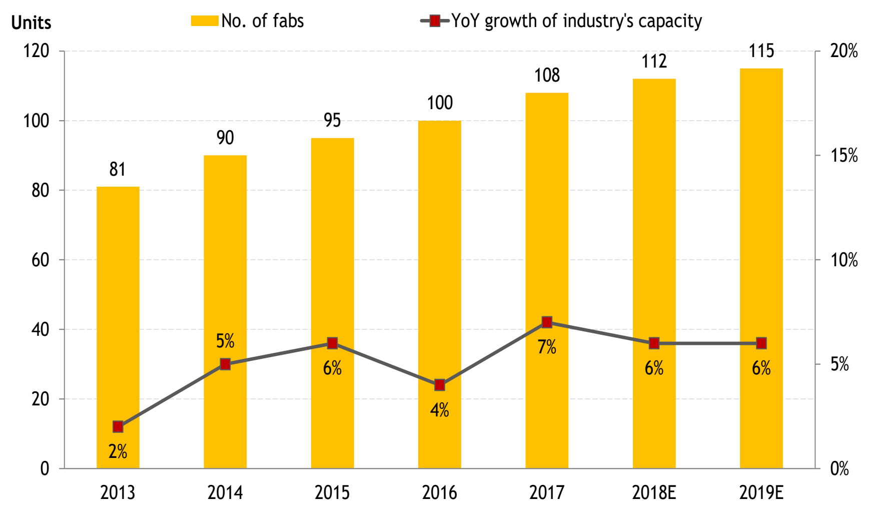
**Fig 18: Smartphone user penetration as % of the total global population**




*Source: Statista*

With the number of fabs and installed capacity of logic semiconductors worldwide set to expand, there will be more precision cleaning jobs created from an increase in new equipment. According to *Statista*, the number of foundry fabs processing 300mm wafers worldwide is expected to increase from 108 fabs in 2017 to 115 by 2019, with installed capacity to increase by 6% in 2018 and in 2019 (Fig. 19).

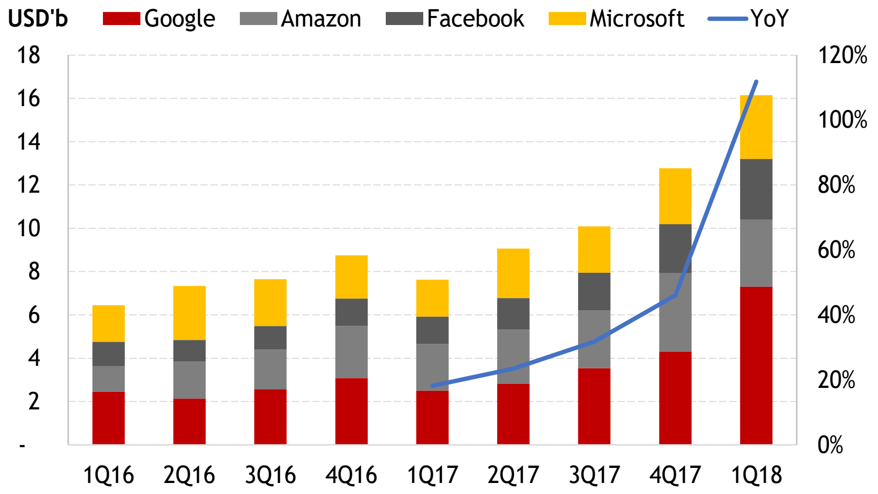
**Fig 19: No. of fabs and installed capacity growth worldwide**




*Source: Statista*

Compared with logic semiconductors, Maybank KE's regional technology analyst, Stefan Chang, believes that the market cycle of memory-DRAM is healthier and could last longer due to structural changes of demand and supply. Demand for DRAM is much more resilient driven by strong data centre growth. Evidently, combined capex from Facebook, Amazon, Microsoft, and Google (FAMG) reached USD16b, +112% YoY compared to +11% YoY in 2017 (Fig. 20);The top 7 cloud service providers together increased their capex by 40% YoY in 1Q18 compared with their original 30% expectation.

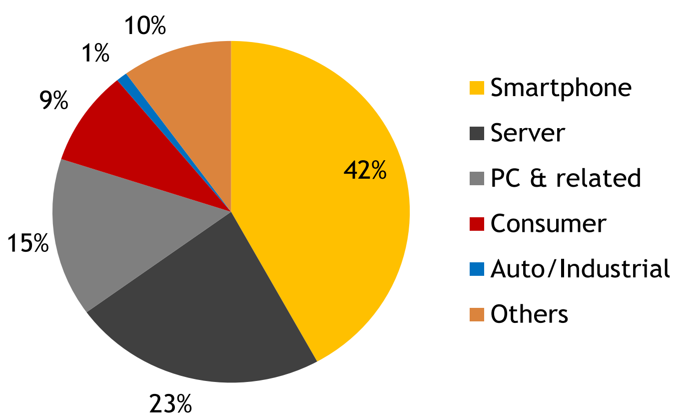
**Fig 20: Combined capex of Facebook, Amazon, Microsoft and Google**




*Source: Company data*

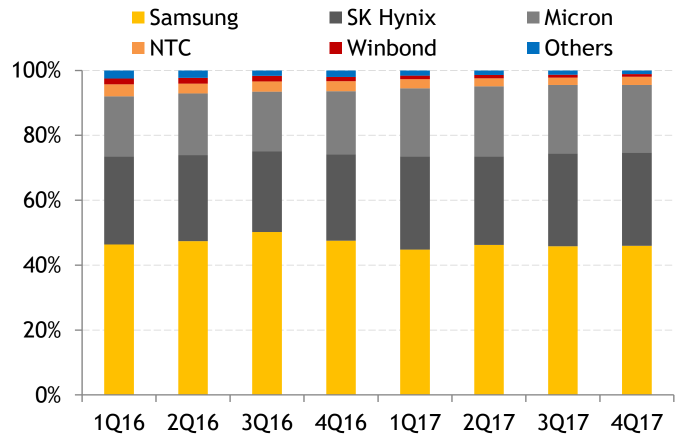
More interestingly, real estate investment for data centre construction increased by 250% YoY last year, which should be a good leading indicator for future data centre growth. Server DRAM growth is 75% faster than for mobile DRAM and can potentially overtake smartphones as the application that consumes the most DRAM in the next few years.

**Fig 21: 2017 DRAM demand breakdown**




*Source: IDC, Company data*

**Fig 22: Market share of DRAM suppliers**



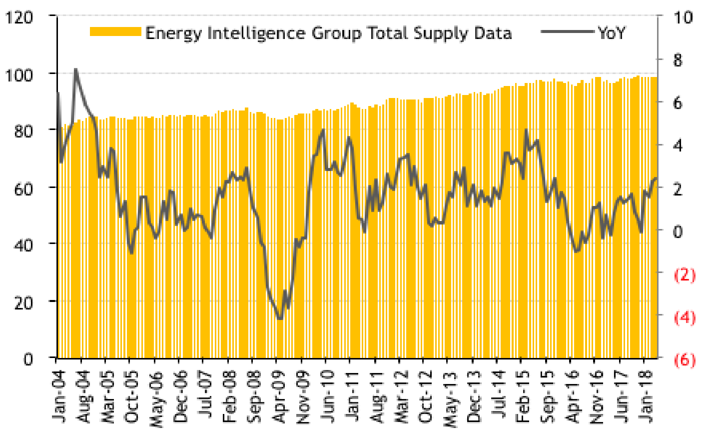

*Source: Company data*

On the supply side, Stefan Chang thinks DRAM suppliers remain disciplined in capacity expansion even with YoY capex increase as capex for D1X (first generation of 10nm) is roughly 30% more than 20nm for the same capacity. He also believes the increasing capital return for Samsung and Micron is the best evidence of their rational expansion.

## O&G market is on a recovery trend

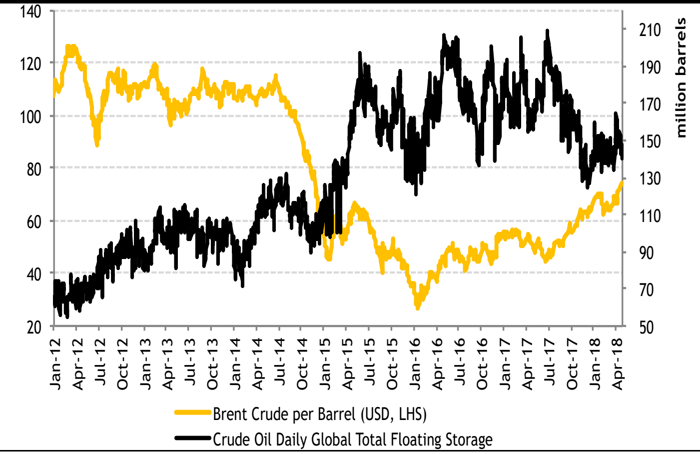
Our regional O&G analyst, TJ Liaw, remains POSITIVE on the sector. Our in-house crude oil price estimate is USD70-75/bbl for 2018-19. Aside from geopolitical supply risk (instability in the Middle East), he does not rule out oil price sustaining at current levels as fundamentals improve with a narrowing of global net crude supply (Fig. 23); global crude oil inventories are falling and offshore storage is on a downtrend (Fig. 24). These events, however, have trumped the potential adverse impact of increased shale supply on oil prices.

**Fig 23: Global oil supply**




*Source: EIA*

**Fig 24: Oil price vs. offshore floating storage**




*Source: Maybank KE*

According to TJ Liaw, OPEC's decision to lower over-compliance and adjust to 100% compliance reflects a tighter control of additional crude oil supply entering the market. The decision made by OPEC, together with Russia, reflects its prominence as a swing producer that offers the flexibility to adjust output while still capping a floor price of USD70/bbl.

Overall, we look for increasing opportunities for Frontken to secure more thermal spray coating jobs from recovering O&G activities. The O&G activities in Malaysia should improve pursuant to an increase in Petronas' capex to MYR55b this year from MYR45b last year. In sum, we assume the contribution from the O&G segment to Frontken's revenue from its operations in Malaysia, Singapore and Indonesia will gain traction in 2H18 and continue into the following years.

# Financial Analysis

### Fig 25: Condensed financial statements (as of 18th July 2018)

| P&L (Dec yr-end) | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| **Revenue** | **262** | **297** | **323** | **365** | **410** |
| Cost of sales | (183) | (192) | (201) | (225) | (248) |
| **Gross profit** | **78** | **105** | **122** | **140** | **161** |
| SG&A | (40) | (49) | (56) | (62) | (69) |
| Other income | 7 | 3 | 3 | 3 | 3 |
| Other expenses | (12) | (13) | (14) | (16) | (18) |
| **EBITDA** | **51** | **65** | **74** | **84** | **96** |
| **EBIT** | **33** | **46** | **55** | **65** | **77** |
| Finance income | 1 | 1 | 0 | 0 | 0 |
| Finance costs | (1) | (1) | (1) | (1) | (1) |
| Associate income | (0) | (0) | (0) | (0) | (0) |
| **PBT** | **33** | **46** | **55** | **65** | **77** |
| Income tax | (6) | (10) | (13) | (15) | (18) |
| Minority interest | (7) | (7) | (5) | (6) | (7) |
| **PAT** | **20** | **30** | **37** | **44** | **52** |
| **Core NPAT** | **18** | **34** | **37** | **44** | **52** |

| B/S (Dec yr-end) | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| **Cash & cash equivalents** | **102** | **129** | **172** | **216** | **266** |
| Receivables | 101 | 97 | 96 | 108 | 121 |
| Inventories | 11 | 13 | 13 | 14 | 16 |
| Other current assets | 3 | 3 | 3 | 3 | 3 |
| **Current assets** | **217** | **242** | **283** | **341** | **406** |
| PP&E | 152 | 150 | 140 | 129 | 119 |
| Fixed deposits | 1 | 1 | 1 | 1 | 1 |
| Other assets | 37 | 37 | 37 | 37 | 37 |
| **Non-current assets** | **191** | **189** | **178** | **168** | **157** |
| **Total assets** | **408** | **431** | **461** | **508** | **563** |
| ST borrowings | 8 | 17 | 15 | 14 | 12 |
| Payables | 73 | 80 | 79 | 89 | 98 |
| Other current liabilities | 5 | 13 | 12 | 12 | 12 |
| **Current liabilities** | **87** | **109** | **107** | **115** | **123** |
| LT borrowings | 20 | 12 | 10 | 9 | 8 |
| Deferred taxes | 2 | 1 | 1 | 1 | 1 |
| Other liabilities | 3 | 3 | 3 | 3 | 3 |
| **Non-current liabilities** | **25** | **16** | **15** | **14** | **13** |
| **Shareholders' funds** | **262** | **282** | **311** | **346** | **388** |
| Minorities | 34 | 24 | 29 | 34 | 39 |
| **Total stockholders' equity** | **295** | **306** | **340** | **380** | **427** |
| **Total equity & liabilities** | **408** | **431** | **461** | **508** | **563** |

| KEY METRICS | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| **Growth (% YoY):** | | | | | |
| Revenue | -6.7% | 13.3% | 9.0% | 12.9% | 12.2% |
| Gross profit | 37.6% | 33.6% | 16.3% | 14.9% | 15.3% |
| EBIT | 102.7% | 36.8% | 19.3% | 18.5% | 18.6% |
| EBITDA | 46.5% | 86.0% | 13.9% | 13.8% | 14.4% |
| PBT | 108.4% | 38.4% | 18.6% | 18.8% | 18.8% |
| Core NPAT | 204.4% | 92.7% | 6.8% | 18.8% | 18.8% |
| EPS | 202.2% | 92.7% | 6.8% | 18.8% | 18.8% |
| **Margin (%):** | | | | | |
| Gross | 30.0% | 35.3% | 37.7% | 38.3% | 39.4% |
| EBIT | 12.9% | 15.6% | 17.1% | 17.9% | 18.9% |
| EBITDA | 19.5% | 21.8% | 22.8% | 23.0% | 23.4% |
| PBT | 12.7% | 15.6% | 16.9% | 17.8% | 18.9% |
| Core NPAT | 6.8% | 11.6% | 11.4% | 12.0% | 12.7% |

| C/F (Dec yr-end) | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| **PBT** | **33** | **46** | **55** | **65** | **77** |
| Depreciation | 17 | 18 | 19 | 19 | 18 |
| Working capital | 1 | 7 | 1 | (4) | (5) |
| Net interest expense | 0 | 0 | 0 | 0 | 0 |
| Tax paid | (7) | (8) | (13) | (15) | (18) |
| Others | (1) | 5 | 0 | 0 | 0 |
| **Operating cash flow** | **44** | **69** | **62** | **65** | **73** |
| **Capex** | **(28)** | **(20)** | **(8)** | **(8)** | **(8)** |
| Investments | (10) | (11) | 0 | 0 | 0 |
| Others | 2 | (1) | 0 | 0 | 0 |
| **Investing cash flow** | **(35)** | **(32)** | **(8)** | **(8)** | **(8)** |
| **Free cash flow** | **17** | **49** | **54** | **57** | **65** |
| Dividend paid | 0 | (5) | (7) | (9) | (10) |
| Net borrowings | (14) | 0 | (3) | (3) | (2) |
| Others | (4) | (3) | (2) | (2) | (2) |
| **Financing cash flow** | **(18)** | **(8)** | **(13)** | **(13)** | **(15)** |
| Net cash flow | (9) | 29 | 42 | 44 | 50 |
| Beginning | 94 | 89 | 119 | 162 | 206 |
| FX | 3 | 2 | 0 | 0 | 0 |
| Ending cash | 89 | 119 | 162 | 206 | 256 |

| PER SHARE | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| No.of shares (million) | 1,041 | 1,048 | 1,048 | 1,048 | 1,048 |
| Diluted EPS (sen) | 2 | 3 | 4 | 4 | 5 |
| BPS (sen) | 25 | 26 | 29 | 33 | 38 |
| DPS (sen) | 0.0 | 0.5 | 0.7 | 0.8 | 1.0 |
| FCF (sen) | 1.6 | 4.7 | 5.2 | 5.5 | 6.2 |

| VALUATION | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| PER (x) | 29.0 | 15.0 | 14.1 | 11.9 | 10.0 |
| PER - excld net cash (x) | 23.7 | 11.4 | 9.5 | 7.0 | 4.9 |
| P / NTA (x) | 2.0 | 1.9 | 1.7 | 1.5 | 1.3 |
| Dividend yield (%) | 0.0 | 1.0 | 1.4 | 1.7 | 2.0 |
| - Payout ratio (%) | 0% | 18% | 20% | 20% | 20% |
| P / FCF (x) | 32.9 | 10.8 | 9.7 | 9.2 | 8.1 |
| EV / EBIT (x) | 14.4 | 9.6 | 7.3 | 5.5 | 4.1 |
| EV / EBITDA (x) | 9.6 | 6.9 | 5.5 | 4.3 | 3.3 |

| BALANCE SHEET | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|
| Receivable days | 128 | 116 | 102 | 102 | 102 |
| Inventory days | 23 | 23 | 23 | 23 | 23 |
| Payable days | 52 | 37 | 37 | 37 | 37 |
| Cash conversion cycle | 98 | 101 | 87 | 87 | 87 |
| Net gearing / (net cash) (%) | (25.0) | (34.9) | (46.3) | (55.1) | (62.8) |

| DuPont | 2016 | 2017 | 2018E | 2019E | 2019E |
|---|---|---|---|---|---|
| **Three-stage** | | | | | |
| - Net profit margin | 12.9% | 15.6% | 17.1% | 17.9% | 18.9% |
| - Asset turnover | 0.7 | 0.7 | 0.7 | 0.8 | 0.8 |
| - Equity multiplier | 1.6 | 1.5 | 1.5 | 1.5 | 1.5 |
| **Five-stage** | | | | | |
| - Tax burden | 81.8% | 78.9% | 76.8% | 76.8% | 76.8% |
| - Interest burden | 98.9% | 99.8% | 99.2% | 99.5% | 99.7% |
| - Operating margin | 12.9% | 15.6% | 17.1% | 17.9% | 18.9% |
| - Asset turnover | 0.7 | 0.7 | 0.7 | 0.8 | 0.8 |
| - Equity multiplier | 1.6 | 1.5 | 1.5 | 1.5 | 1.5 |
| **Return on equity** | **11.0%** | **13.4%** | **14.2%** | **15.2%** | **16.2%** |

*Source: Company data, Maybank KE*

## Profit & loss analysis

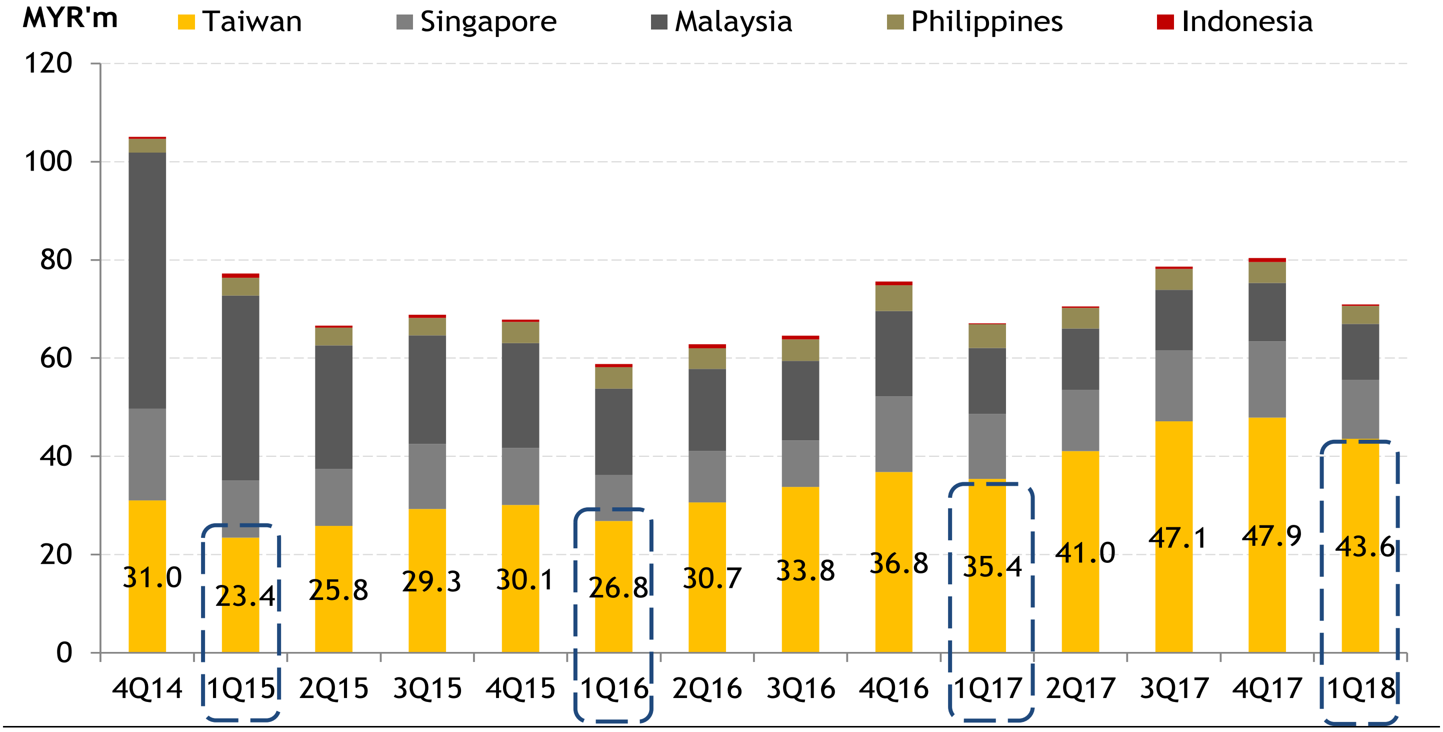
### Revenue to chalk up CAGR of 11.4% for FY17-20E

We forecast FY18E/19E/20E revenue growth of 9%/12.9%/12.2%, which translates to a 3-year CAGR of 11.4%. We expect the growth to be sourced mainly from its cleaning and coating services to foundry companies and memory manufacturers in the semiconductor market. The contribution of these segments is almost 80% of the Group's revenue, and we estimate they will generate strong revenue CAGR of 10.3% over the next year three years.

As depicted in Fig. 26, the Group's revenues have tended to be cyclical since 2015, particularly from its semiconductor business in Taiwan. The revenue contribution from Taiwan peaked in the fourth quarter of 2017 and troughed in the first quarter of this year. Revenues have reportedly improved thus far in the second quarter of the year.

Any sustained improvement in the chip demand cycle will depend on the increasing activities of its customers' semiconductor wafer fabrication, which in turn will be driven by chips with improved performance and power consumption in smartphones and electronic devices in the second half of the year.

**Fig 26: Revenue cycle for Frontken's subsidiaries over the last three years**




*Source: Company data*

### Cost structure

Raw materials comprise about 33% of COGS and these include substances such as thermal coating powders, wires and rods. Raw materials are locally sourced where their operations are located. The balance of COGS comprises labour (33%), overhead (24%) and depreciation (10%). As new equipment is installed, we expect the Group to incur a slight increase of 3% in depreciation expense in FY19.

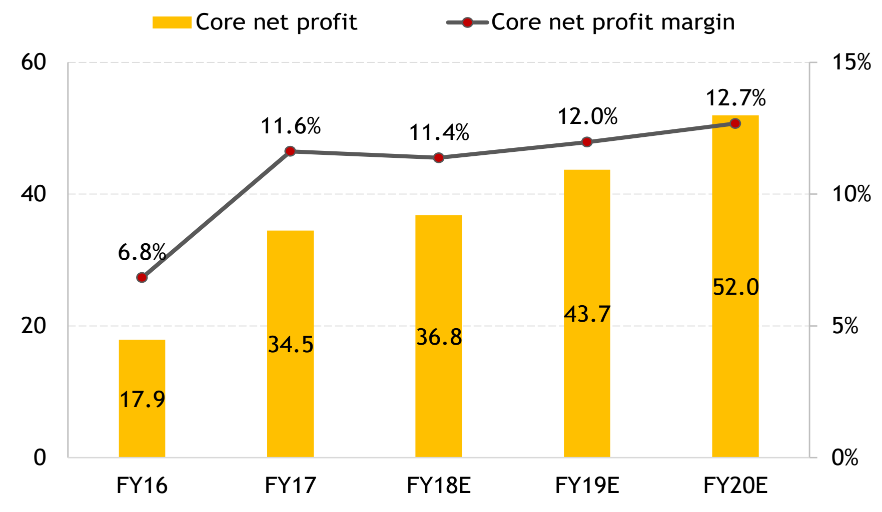
## Forex exposure

The Group's revenue contributions and COGS are largely transacted in local currencies of those countries in which its subsidiaries operate, and are subject to translation gains or losses. The only exposure to the USD is from most of the transactions of its Singapore business segment; but its revenue and EBIT contributions to the Group are less than 20% and 10%, respectively. We roughly estimate that every 1% weakness in the MYR from our base case would impact our core net profit estimates by about 2%.

## Core net profit CAGR of 14.7% FY17-20E

All in all, we forecast the Group's core net profit to increase by 6.8%/18.8%/18.8% in FY18E/19E/20E, which translates to a 3-year CAGR of 14.7% (Fig. 27). The growth will be fuelled by: (i) higher topline growth driven by strong orders for its services following higher fab production at both foundry and memory companies; and (ii) higher gross margins for services on smaller node technological process. Our estimates imply net profit margins will likely improve to 12.7% in FY20 from 11.6% in FY17.

**Fig 27: Core net profit trend**




*Source: Company data, Maybank KE*

## Sensitivity analysis

In terms of earnings sensitivity, we estimate that every 1% change in revenue of Frontken's Taiwan operations from our base case only will impact our estimate of Group core net profit by 0.9%. The major drivers of our revenue estimates are orders growth for Frontken's services and margin improvement, which are dependent upon foundries, especially companies' existing and new capacity expansion in Taiwan, as well as robust wafer fabrication activities at 200mm wafer fabs in Taiwan and Singapore.

## 1QFY18 results review

1QFY18 revenue rose 5.8% YoY to MYR70.9m (5.8% YoY) on an improved semiconductor business in the quarter. EBITDA and core net profit margin expanded 1.0%-pts YoY and 1.4-pts YoY to 20.1% and 8.9%. 1QFY18 core net profit, however, slipped marginally to MYR6.7m (-3.6% YoY) due to a marginal increase in depreciation of 0.7% to MYR4.5m and higher tax expense following operating losses. We opine that losses in the O&G segments in Singapore and Indonesia were unable to be offset against profitable operations.

On a quarterly basis, 1QFY18 core net profit decreased 45.7% QoQ due to higher tax expense and an 11.8% decrease in revenue. EBITDA and core net profit margin shrank 1.8%-pts YoY and 14%-pts YoY to 20.1% and 8.9%. The QoQ revenue decrease was expected as the contribution from the Taiwan segment tends to trough in the first quarter due to lower customer business activities following the CNY holidays.

We assume the growth from semiconductor revenue contribution will only increase moderately this year due to the cautious demand outlook for the new model of smartphones. We have factored in this downside risk, in-line with our in-house view that upstream activities are still exposed to soft premium smartphone demand in 2H18, which implies slower orders for Frontken's services.

However, we believe wafer fabrication activities will remain sustainable on the back of customer demand for legacy and low-end models of smartphones and growing in other end use markets (Fig. 17). We expect the Group's revenue and earnings to also be supported by a recovery in the O&G segment's orders in 2H18 but overall earnings growth will taper to 6.8%YoY due to a high base effect.

**Fig 28: Summary results table**

| FYE Dec (MYR'm) | 1Q18 | 1Q17 | %YoY | 4Q17 | %QoQ |
|---|---|---|---|---|---|
| **Revenue** | **70.9** | **67.1** | **5.8** | **80.4** | **(11.8)** |
| **EBITDA** | **14.2** | **12.8** | **11.6** | **17.6** | **(19.2)** |
| Depreciation | (4.5) | (4.4) | 0.7 | (4.7) | (4.8) |
| Other income | 1.4 | 1.0 | 34.6 | 1.0 | 42.9 |
| **EBIT** | **11.1** | **9.3** | **19.3** | **13.9** | **(19.8)** |
| Finance income | 0.2 | 0.2 | (29.6) | 0.2 | (11.1) |
| Finance costs | (0.2) | (0.2) | 10.2 | (0.2) | (7.0) |
| Associate profit/loss | (0.0) | (0.0) | 28.6 | 0.0 | >100 |
| **PBT** | **11.0** | **9.3** | **18.3** | **13.6** | **(19.1)** |
| Tax expense | (3.8) | (2.9) | 35.0 | (2.4) | 62.1 |
| **Headline net profit** | **6.3** | **5.0** | **25.5** | **11.3** | **(44.0)** |
| **Core net profit** | **6.7** | **7.0** | **(3.6)** | **12.4** | **(45.7)** |
| | | | | | |
| Basic EPS (sen) | 0.60 | 0.48 | 25.0 | 0.94 | (36.2) |
| | | | | | |
| **Margin (%)** | **1Q18** | **1Q17** | **+/- ppt** | **4Q17** | **+/- ppt** |
| EBITDA | 20.1 | 19.0 | 1.0 | 21.9 | (1.8) |
| EBIT | 15.7 | 13.9 | 1.8 | 17.3 | (1.6) |
| PBT | 15.6 | 13.9 | 1.7 | 17.0 | (1.4) |
| Core net profit | 8.9 | 7.5 | 1.4 | 15.4 | (14.0) |
| | | | | | |
| Net gearing (x) | net cash | net cash | nm | net cash | nm |
| | | | | | |
| **Segmental revenue (MYR'm)** | **1Q18** | **1Q17** | **%YoY** | **4Q17** | **%QoQ** |
| Taiwan | 43.6 | 35.4 | 23.2 | 47.9 | (9.0) |
| Singapore | 12.0 | 13.3 | (9.6) | 15.5 | (22.7) |
| Malaysia | 11.4 | 13.4 | (15.1) | 11.9 | (4.3) |
| Philippines | 3.7 | 4.8 | (23.6) | 4.2 | (13.7) |
| Indonesia | 0.3 | 0.2 | 66.7 | 0.8 | (65.4) |
| | | | | | |
| **Segmental EBIT (MYR'm)** | **1Q18** | **1Q17** | **%YoY** | **4Q17** | **%QoQ** |
| Taiwan | 10.5 | 7.2 | 46.5 | 11.1 | (5.1) |
| Singapore | (0.5) | 0.2 | >-100 | 2.4 | >-100 |
| Malaysia | 1.0 | 1.5 | (32.3) | 0.1 | >100 |
| Philippines | 0.6 | 0.9 | (35.4) | 0.3 | 68.3 |
| Indonesia | (0.5) | (0.5) | (2.5) | (0.2) | >100 |

*Source: Company data*

### Resuming dividend payout

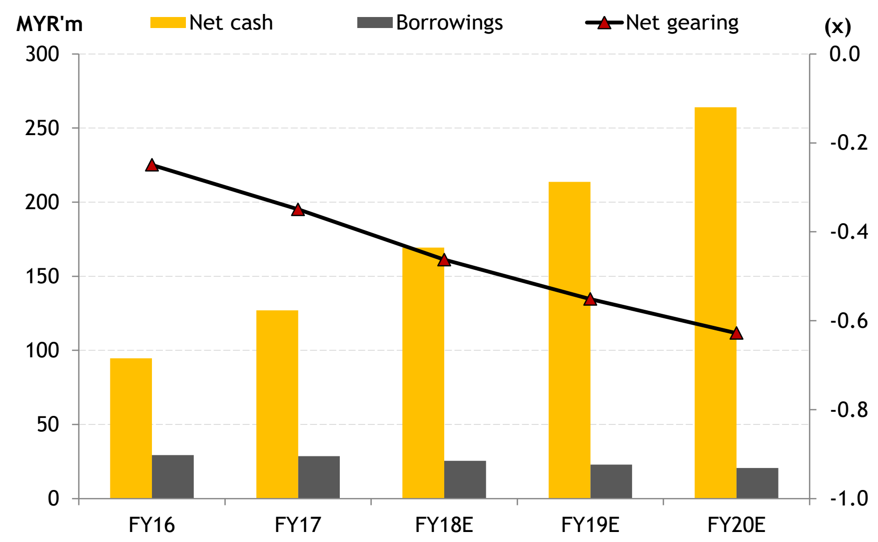
The Group does not have a formal dividend policy but it resumed paying a dividend of 0.5sen last year for the first time since 2011. The resumption of the dividend follows a remarkable record high headline Group net profit of MYR29.9m last year. The Group is expected to maintain a dividend payout of approximately 20%. In our forecast, we have assumed a DPS of 0.7sen/0.8sen/1sen in FY18E/19E/20E, representing a payout ratio of 20%.

## Balance sheet analysis

### Net cash position

The Group has a healthy balance sheet with low borrowings and strong cash flows (Fig. 29). As at end-Mar 2018, its net cash position and borrowings stood at MYR95.2m (9sen/share) and MYR26.8m, respectively. This has helped the Group to flexibly spend on new equipment in the last two years. We assume its net cash position will expand due to healthy cash flow generation.

**Fig 29: Gearing trend**




*Source: Company data, Maybank KE*

## Cash flow analysis

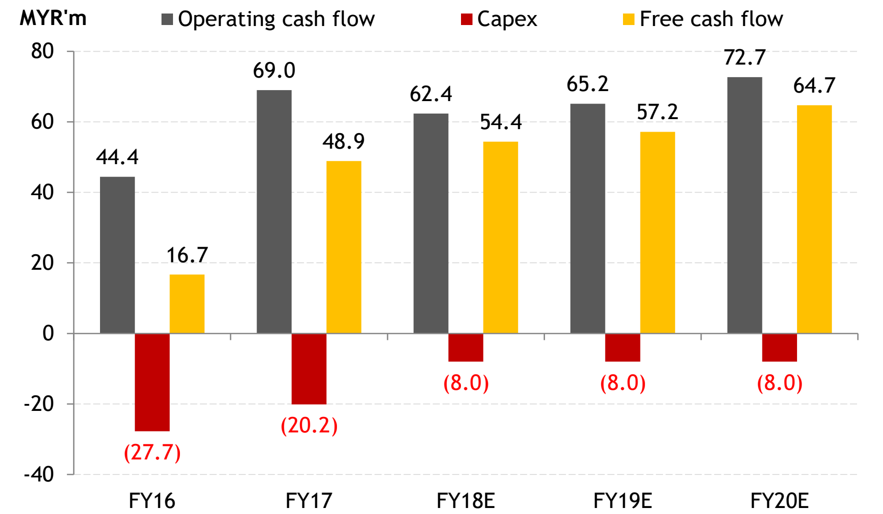
### Strong free cash flow (FCF)

The Group's FCF has increased the last two years, despite having spent MYR40m on new equipment (Fig. 30). We expect FCF to remain positive as more cash will be generated at the operating level due from net profit growth and good working capital management.

## Capital expenditure (CAPEX)

We expect the Group's capex to return to historical norms. We assume its CAPEX is budgeted at approximately MYR8m for maintenance of existing equipment the next three years. No large capex is required at this juncture as the capex spend of MYR40m in the previous two years has given the company adequate production capacity and advanced technology to meet the increasing demand for its high quality services in the foreseeable future.

**Fig 30: Positive trend in OCF and declining CAPEX supporting high FCF**




*Source: Company data, Maybank KE*

# Valuation

## Initiate with BUY and MYR0.63 TP

We initiate coverage of Frontken with a BUY recommendation and TP of MYR0.63. Our TP is based on a target PER of 15x FY19E EPS of 4.2sen, which is 0.5 standard deviation above its 3-year average historical forward PER of 12x. This translates to a FY19 P/NTA of 1.5x and a FY19E PER excluding net cash of 7.0x, which we think is attractive given that we estimate a robust 3-year earnings CAGR of 14.7% in FY17-20E.

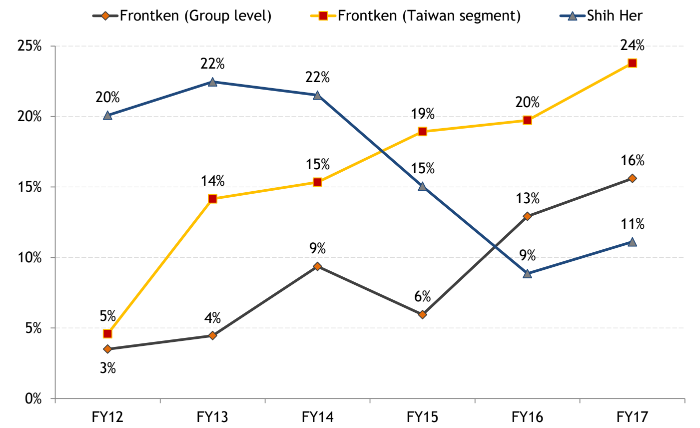
As Frontken's earnings are largely contributed by the semiconductor segment in Taiwan, we think the most direct comparable peer is Shih Her, Kertz (private company), Leanteq (private company) and Taiyah (private company). There are no direct comparable peers in Malaysia for the same operation. Globally, most comparable peers are private companies (e.g. Quantum Clean in the U.S.).

Shih Her is the largest precision cleaning provider in terms of revenue; Ares Green has been more profitable vs. Shih Her. There are no consensus earnings forecasts for Shih Her but historically, Frontken has traded at a lower 3-year average PER of 12x (Fig. 34) vs. Shih Her's 16.6x. This was despite Frontken's superior ROE (Fig. 32).

## Against Malaysia's technology players

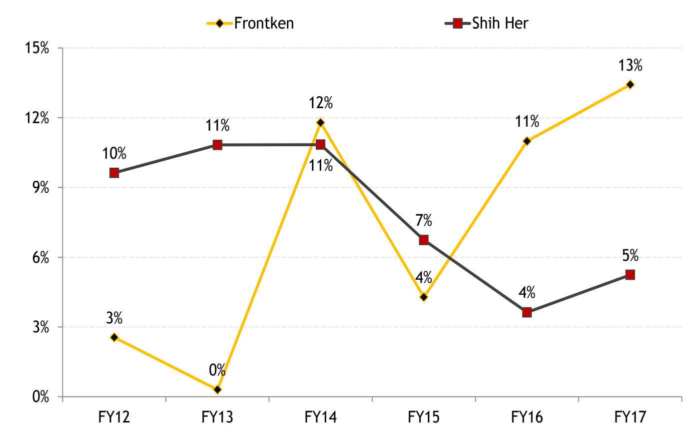
Almost all of Malaysia's technology companies are involved in the semiconductor value chain. Frontken's focus is on providing services to global foundry companies in the upstream value chain. Although not directly comparable, these companies follow the global semiconductor cycle. As such, we think that our target PER of 15x is still conservative relative to the present local semiconductor players' weighted average FY19 PER of 16.8x (Fig. 33).

**Fig 31: Frontken's and Shih Her's historical EBIT margin**




*Source: Company data, Bloomberg*

**Fig 32: Frontken's and Shih Her's historical ROE**



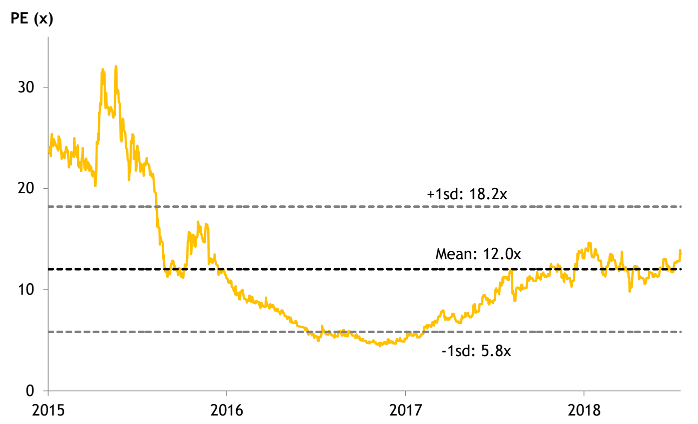

*Source: Company data, Bloomberg*

## Fig 33: Peer comparison (as of 18th July 2018)

| Company | Blmbrg Code | MKE Rec | Price (LC) | MKE TP (LC) | Mkt Cap (USD'm) | P/E (x) CY17A | P/E (x) CY18E | P/E (x) CY19E | P/B (x) CY17A | P/B (x) CY18E | P/B (x) CY19E | ROE (%) CY17A | ROE (%) CY18E | ROE (%) CY19E | Yield (%) CY17A | Yield (%) CY18E | Yield (%) CY19E | EPS CAGR (%) (CY17/20F) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Frontken Corp | FRCB MK | BUY | 0.50 | 0.63 | 128 | 15.0 | 14.1 | 11.9 | 1.7 | 1.5 | 1.4 | 11.3 | 10.8 | 11.5 | 1.0 | 1.4 | 1.7 | 14.7 |
| **Precision cleaning** | | | | | | | | | | | | | | | | | | |
| Shih Her Technologies Inc | 3551 TT | NR | 32.20 | - | 60 | 13.5 | na | na | 0.7 | na | na | 5.2 | na | na | 3.1 | na | na | na |
| Komico Ltd | 183300 KS | NR | 32.7k | - | 244 | 14.9 | 10.8 | 8.9 | 4.0 | 3.0 | 2.3 | 26.6 | 27.5 | 25.7 | 1.5 | 1.0 | 1.2 | 26.7 |
| **Weighted average** | | | | | | **14.6** | **10.8** | **8.9** | **3.3** | **3.0** | **2.3** | **22.4** | **27.5** | **25.7** | **1.8** | **1.0** | **1.2** | |
| **MY Technology** | | | | | | | | | | | | | | | | | | |
| Inari Amertron | INRI MK | BUY | 2.41 | 2.80 | 1,864 | 29.7 | 21.9 | 17.9 | 8.2 | 7.4 | 6.6 | 29.0 | 35.3 | 38.5 | 2.6 | 3.2 | 3.9 | 30.5 |
| V.S. Industry | VSI MK | BUY | 1.67 | 2.70 | 695 | 15.8 | 13.5 | 10.6 | 2.5 | 2.3 | 2.1 | 18.1 | 19.4 | 22.2 | 3.5 | 4.0 | 5.0 | 18.7 |
| Vitrox Corp | VITRO MK | HOLD | 5.49 | 5.09 | 636 | 31.5 | 28.1 | 20.8 | 7.8 | 6.5 | 5.2 | 24.8 | 23.1 | 25.2 | 0.8 | 0.9 | 1.2 | 22.8 |
| Mms Ventures | MMSV MK | BUY | 1.41 | 2.02 | 55 | 10.7 | 12.5 | 9.4 | 3.9 | 3.2 | 2.6 | 35.9 | 25.3 | 27.3 | 1.4 | 2.8 | 2.3 | 7.4 |
| Globetronics Technology | GTB MK | HOLD | 2.44 | 2.30 | 401 | 32.6 | 26.3 | 18.9 | 5.8 | 5.4 | 5.0 | 17.8 | 20.7 | 26.5 | 3.0 | 2.7 | 3.7 | 21.2 |
| Kesm Industries | KESM MK | NR | 16.70 | - | 177 | 16.3 | 17.3 | 13.9 | 2.2 | 1.9 | 1.7 | 13.4 | 11.3 | 12.4 | 0.2 | 0.8 | 1.1 | 11.7 |
| D&O Green Technologies | DOGT MK | NR | 0.70 | - | 178 | 32.3 | 17.4 | 13.6 | 3.2 | 3.3 | 3.0 | 10.2 | 19.6 | 23.0 | 0.0 | 1.4 | 1.4 | na |
| Elsoft Research | ELSR MK | NR | 2.70 | - | 184 | 25.0 | 20.7 | 18.2 | 4.5 | na | na | 18.2 | na | na | 3.7 | 3.4 | 3.4 | 13.1 |
| Pentamaster Corp | PENT MK | NR | 2.73 | - | 213 | 24.0 | na | na | 2.2 | na | na | 9.2 | na | na | 0.0 | na | na | na |
| **Weighted average** | | | | | | **26.9** | **21.3** | **16.8** | **6.1** | **5.7** | **5.0** | **23.0** | **27.3** | **30.4** | **2.2** | **2.8** | **3.4** | |

*Source: Bloomberg, Maybank KE*

## Fig 34: Frontken's 1-year forward PER




*Source: Bloomberg*

## Fig 35: Frontken's 1-year forward PBV


*Source: Bloomberg*

# Risks

## General economic risk

Growth in the Group's services is indirectly affected by the strength of consumer behaviour in general. Inflationary pressure, coupled with higher cost of living could dent consumption growth and spending on new smartphones, computing and electronic products. A weak business outlook would also adversely impact investment on new advanced technologies in the auto market, data centre market, and many more. As a result, it would lower the utilisation of wafer fabrication equipment.

## Reliance on semiconductor industry

The semiconductor industry (in particular, the upstream) is cyclical and has historically experienced periodic downturns. As 80% of the Group's revenue is derived from the semiconductor market, any downturn in the semiconductor industry would adversely affect the utilisation rates of wafer fabrication (production) equipment, which in turn, would reduce the demand for thermal spray coating and precision cleaning services.

## Semiconductor industry technology challenges

As wafer and technology nodes get more complex, it is becoming increasingly expensive to keep the price of wafers down and shrink the size of the nodes. Therefore, these cost pressures for some foundry companies would erode investments in order to produce better performance chips. This would deter Frontken from generating a positive return on capital for its new equipment to cater to the new process. In other words, the Group could face a margin squeeze when costs for wafer fabrication increase.

## Instability in oil price trend

The fall or uncertainty in the trend for crude oil prices could lead to oil majors cutting their capital expenditure (capex). This would derail O&G activities to the sector, which in turn would lower the utilization rate of O&G equipment and petrochemical production facilities.

## Foreign exchange risk

The Group's sales and purchases are denominated in local currencies of the countries in which it operates. That said, it has forex exposure to the USD in its Singapore segment, and the Group does not have a formal hedging policy. Based on our sensitivity analysis, every 1% decrease in the MYR/USD from our base case would impact our core net profit estimates by less than 2%. The remaining forex exposure is subject to translation risks as its consolidated financial statements are denominated in MYR. As such, any material fluctuations in foreign exchange rates will result in translation gains or losses on consolidation.

# Appendix I

**Fig 36: Frontken's management team**

| Name | Position | Details |
|---|---|---|
| Ng Wai Pin | Chairman / Chief Executive Officer | • His role was re-designated to Chairman/CEO on 29 Mar 2018<br>• Appointed as Chairman/Managing Director on 19 Jan 2012<br>• Graduated with Bachelor of Laws from University of Auckland |
| Hee Kok Hiong | Chief Financial Officer | • Appointed in 2012<br>• A Fellow member of the Chartered Association of Certified Accountants (UK) and Chartered Accountant of the Malaysian Institute of Accountants<br>• >20 years' experience in finance and administration<br>• Also sits on the board of the Frontken's subsidiary, Ares Green Technology Corporation |
| Lee Boon Tian | Director of Frontken Malaysia Sdn Bhd | • Appointed as ED on 5 Oct 14<br>• Graduated from Cambridge Management Institute, UK with a MBA<br>• >30yrs of accounting and finance experience, >25yrs managerial capacity overseeing to financial matters |
| Mohd Shukri Bin Hitam | Managing Director of TTES Frontken Integrated Services Sdn Bhd | • Date of appointment: 1 Aug 16<br>• Holds a Bachelor of Science in Aerospace Engineering and a Bachelor of Science in Aeronautics<br>• Has extensive working experience in engineering related fields |
| George I. Lagos | President, Frontken Philippines Inc. | • Appointed in 2003<br>• Graduated from Don Bosco Technical College, Industrial Technology \ Course<br>• Has extensive working experience in the oil and gas industry, power and related industrial fields |
| Tsai Yu Min | General Manager, Ares Green Technology Corporation | • Appointed in 2013<br>• Graduated with a Degree in Chemical Engineering from Taiwan Taichung Feng Chia University<br>• Has extensive working experience in sales and marketing and general management |
| Mok Siew Wai | Chief Operating Officer, Frontken (Singapore) Pte Ltd | • Appointed in 2013<br>• Graduated with a Diploma in Production Engineering from Singapore Polytechnic and a Diploma in Sales & Marketing from Singapore Institute of Management<br>• Has extensive working experience in the business of rotating equipment repair technology engineering applications in thermal coating processes and services including regional sales and marketing lead functions |
| Png Eng Wah | Senior Vice President, Frontken (Singapore) Pte Ltd | • Appointed in 2004<br>• Graduated with a Diploma in Mechanical Engineering from Ngee Ann Polytechnic, Singapore<br>• Has extensive working experience in the business of surface metamorphosis technology |

*Source: Company data*

| FYE 31 Dec | FY16A | FY17A | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Key Metrics** | | | | | |
| P/E (reported) (x) | 8.3 | 11.1 | 14.1 | 11.9 | 10.0 |
| Core P/E (x) | 9.2 | 9.6 | 14.1 | 11.9 | 10.0 |
| P/BV (x) | 0.6 | 1.2 | 1.7 | 1.5 | 1.3 |
| P/NTA (x) | nm | nm | nm | nm | nm |
| Net dividend yield (%) | 0.0 | 1.6 | 1.4 | 1.7 | 2.0 |
| FCF yield (%) | 10.1 | 14.8 | 10.5 | 11.0 | 12.5 |
| EV/EBITDA (x) | 2.7 | 6.3 | 5.4 | 4.3 | 3.3 |
| EV/EBIT (x) | 4.1 | 8.8 | 7.3 | 5.5 | 4.0 |
| **INCOME STATEMENT (MYR m)** | | | | | |
| Revenue | 261.8 | 296.6 | 323.4 | 365.2 | 409.7 |
| Gross profit | 78.5 | 104.8 | 121.9 | 140.0 | 161.5 |
| EBITDA | 51.0 | 64.8 | 73.8 | 84.0 | 96.0 |
| 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 | 55.2 | 65.4 | 77.6 |
| 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 | 54.7 | 65.0 | 77.3 |
| Income tax | (6.1) | (9.7) | (12.7) | (15.1) | (17.9) |
| Minorities | (7.2) | (6.6) | (5.2) | (6.2) | (7.4) |
| Perpetual securities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Discontinued operations | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Reported net profit | 20.0 | 29.9 | 36.8 | 43.7 | 52.0 |
| Core net profit | 17.9 | 34.5 | 36.8 | 43.7 | 52.0 |
| Preferred Dividends | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **BALANCE SHEET (MYR m)** | | | | | |
| Cash & Short Term Investments | 102.5 | 129.3 | 171.7 | 215.9 | 266.2 |
| Accounts receivable | 101.2 | 97.0 | 95.9 | 108.3 | 121.4 |
| Inventory | 11.0 | 13.5 | 12.7 | 14.2 | 15.6 |
| 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** | **460.9** | **508.5** | **562.9** |
| ST interest bearing debt | 8.7 | 16.9 | 15.1 | 13.6 | 12.2 |
| Accounts payable | 73.3 | 79.6 | 79.0 | 89.1 | 98.4 |
| 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** | **121.3** | **128.9** | **135.8** |
| Shareholders Equity | 261.6 | 281.6 | 311.0 | 346.0 | 387.6 |
| Minority Interest | 33.8 | 24.4 | 28.6 | 33.6 | 39.5 |
| **Total shareholder equity** | **295.4** | **306.0** | **339.6** | **379.6** | **427.1** |
| Perpetual securities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Total liabilities and equity** | **407.8** | **431.1** | **460.9** | **508.5** | **562.9** |
| **CASH FLOW (MYR m)** | | | | | |
| Pretax profit | 33.3 | 46.1 | 54.7 | 65.0 | 77.3 |
| 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 | 1.3 | (3.7) | (5.4) |
| Cash taxes paid | (6.7) | (7.9) | (12.7) | (15.1) | (17.9) |
| Other operating cash flow | (0.9) | 5.4 | 0.1 | 0.1 | 0.1 |
| Cash flow from operations | 44.4 | 69.0 | 62.4 | 65.2 | 72.7 |
| Capex | (27.7) | (20.2) | (8.0) | (8.0) | (8.0) |
| Free cash flow | 16.7 | 48.9 | 54.4 | 57.2 | 64.7 |
| Dividends paid | (2.2) | (7.2) | (8.4) | (10.0) | (11.9) |
| Equity raised / (purchased) | (0.1) | 0.0 | 0.0 | 0.0 | 0.0 |
| Perpetual securities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Change in Debt | (15.1) | (0.2) | (3.2) | (2.5) | (2.3) |
| Perpetual securities distribution | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 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 | 42.3 | 44.3 | 50.3 |

| FYE 31 Dec | FY16A | FY17A | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Key Ratios** | | | | | |
| **Growth ratios (%)** | | | | | |
| Revenue growth | (6.7) | 13.3 | 9.0 | 12.9 | 12.2 |
| EBITDA growth | 46.5 | 26.9 | 13.9 | 13.8 | 14.4 |
| EBIT growth | 102.7 | 36.8 | 19.3 | 18.5 | 18.6 |
| Pretax growth | 108.4 | 38.4 | 18.6 | 18.8 | 18.8 |
| Reported net profit growth | 400.1 | 49.0 | 23.3 | 18.8 | 18.8 |
| Core net profit growth | 204.4 | 92.7 | 6.8 | 18.8 | 18.8 |
| | | | | | |
| **Profitability ratios (%)** | | | | | |
| EBITDA margin | 19.5 | 21.8 | 22.8 | 23.0 | 23.4 |
| EBIT margin | 12.9 | 15.6 | 17.1 | 17.9 | 18.9 |
| Pretax profit margin | 12.7 | 15.6 | 16.9 | 17.8 | 18.9 |
| Payout ratio | 0.0 | 17.5 | 20.0 | 20.0 | 20.0 |
| | | | | | |
| **DuPont analysis** | | | | | |
| Net profit margin (%) | 7.7 | 10.1 | 11.4 | 12.0 | 12.7 |
| Revenue/Assets (x) | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 |
| Assets/Equity (x) | 1.6 | 1.5 | 1.5 | 1.5 | 1.5 |
| ROAE (%) | 8.0 | 11.0 | 12.4 | 13.3 | 14.2 |
| ROAA (%) | 4.5 | 8.2 | 8.3 | 9.0 | 9.7 |
| | | | | | |
| **Liquidity & Efficiency** | | | | | |
| Cash conversion cycle | 19.1 | (0.3) | (11.0) | (12.3) | (13.4) |
| Days receivable outstanding | 133.6 | 120.3 | 107.3 | 100.6 | 100.9 |
| Days inventory outstanding | 22.4 | 23.0 | 23.4 | 21.5 | 21.6 |
| Days payables outstanding | 136.8 | 143.5 | 141.7 | 134.4 | 135.9 |
| Dividend cover (x) | nm | 5.7 | 5.0 | 5.0 | 5.0 |
| Current ratio (x) | 2.5 | 2.2 | 2.7 | 3.0 | 3.3 |
| | | | | | |
| **Leverage & Expense Analysis** | | | | | |
| Asset/Liability (x) | 3.6 | 3.4 | 3.8 | 3.9 | 4.1 |
| 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 | 126.2 | nm | nm |
| Debt/EBITDA (x) | 0.6 | 0.4 | 0.3 | 0.3 | 0.2 |
| Capex/revenue (%) | 10.6 | 6.8 | 2.5 | 2.2 | 2.0 |
| Net debt/ (net cash) | (73.1) | (100.7) | (146.2) | (193.0) | (245.6) |

*Source: Company; Maybank*

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