



Frencken Group Limited

(FRKN SP/FREN.SI)

Too fast too furious

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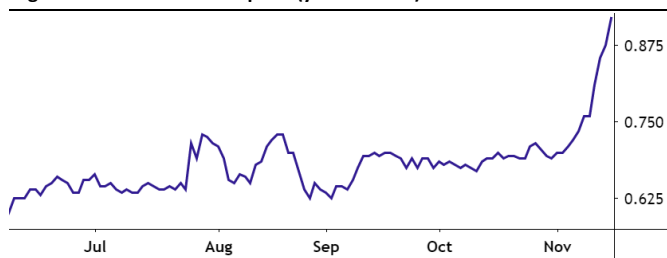
- Frencken's share price has gained 28% since our last report on 7 November, hitting our 12M target price of S\$0.93 in intraday trading on Friday, 15 November
- While we believe in Frencken's long-term fundamentals, we see short-term weakness in its Industrial Automation and Analytical segments
- We downgrade to NEUTRAL as further upside may be limited at its current price. Furthermore, our Taiwan colleagues have turned cautious on the extremely positive sentiment among technology-related stocks

Financials & Key Operating Statistics					
YE Dec (\$m)	2017	2018	2019F	2020F	2021F
Revenue	515.1	625.8	657.1	683.4	710.7
PATMI	33.1	30.0	39.4	38.1	39.5
Core PATMI	23.0	33.9	39.4	38.1	39.5
Core EPS	5.6	8.3	9.6	9.3	9.6
Core EPS grth (%)	44.5	47.7	16.2	-3.3	3.7
Core P/E (x)	16.4	11.1	9.6	9.9	9.5
DPS (\$Gcents)	2.4	2.1	2.6	2.6	2.6
Div Yield (%)	2.6	2.3	2.8	2.8	2.8
Net Margin (%)	6.4	4.8	6.0	5.6	5.6
Gearing (%)	-1.8	0.6	-17.6	-24.7	-31.3
Price / Book (x)	1.5	1.4	1.2	1.1	1.0
ROE (%)	13.3	11.2	12.3	10.9	10.5

Source: Company Data, KGI Research

Share price rally. Frencken's share price surged 28% following a good set of 3Q19 results announced on 6 Nov. As a recap, 3Q19 earnings beat our expectations as its mechatronics division posted 7% YoY and 6% QoQ increase in revenues, which more than offset the ongoing weakness in the IMS business. Semiconductor sales rose 10% YoY and 38% QoQ to the highest in six quarters, while its industrial automation surprised on the upside as sales in this segment increased 23% YoY and 10% QoQ.

Figure 1: Frencken's share price (year-to-date)



Source: Bloomberg, KGI Research

Taming expectations. Frencken's valuations have turned from conservative to neutral over the past few months, and from neutral to slightly expensive last week. While we believe in Frencken's long-term fundamentals, its current valuations of 9-10x FY19-21F P/E may not be sufficient to compensate for the risks arising from two of its major business segments in the next 2-3 quarters. Furthermore, Frencken's management had debunked any potential merger and acquisition (M&A) talks that may have contributed to the c.30% rise in its share price over the past two weeks.

NEUTRAL - Downgrade

Price as of 15 Nov 19 (SGD)	0.92	Performance (Absolute)	
12M TP (\$)	0.93	1 Month (%)	32.4
Previous TP (\$)	0.93	3 Month (%)	29.6
Upside (%)	1.1	12 Month (%)	132.0
Trading data		Perf. vs STI Index (Red)	
Mkt Cap (\$mn)	390		
Issued Shares (mn)	424		
Vol - 3M Daily avg (mn)	2.0		
Val - 3M Daily avg (\$mn)	1.4		
Free Float (%)	62.0%		
Major Shareholders		Previous Recommendations	
Gooi Soon Chai	23.4%	7-Nov-19	OP \$0.93
		10-Sep-19	OP \$0.81
		22-Aug-19	N \$0.81

Our Taiwan colleagues have also echoed mounting speculative sentiment among technology-related stocks as a pivotal sign of share prices reversing in the short term.

Two potential weak segments. While Frencken's semiconductor segment came in stronger-than-expected, management has guided for a weaker YoY and QoQ in its industrial automation segment (most significant revenue contributor in 3Q19). Details following our meeting with management last Friday are thus summarised:

1) Analytical. After revenue peaked in 4Q18, its analytical segment has continued to decline on softer demand from a key client. These are mainly analytical machines used in the semiconductor industry.

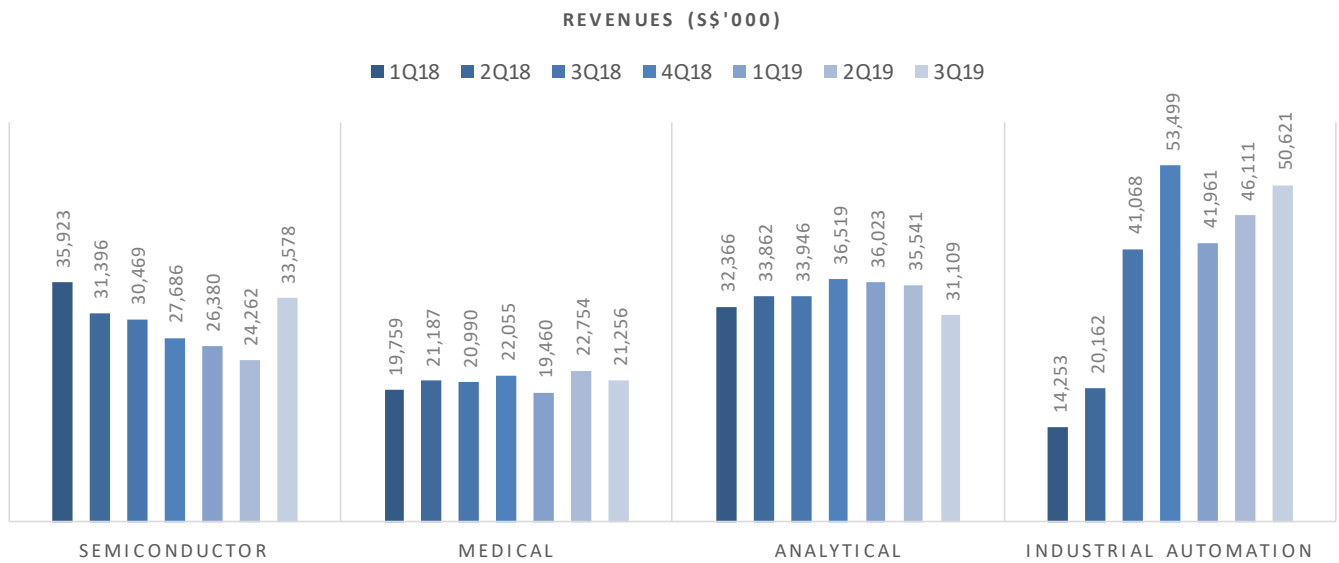
2) Industrial Automation. Management has guided for sales to decline YoY and QoQ in 4Q19. While we remain optimistic on Frencken's well-placed position with its key client, we expect a slowdown in capex in the next 2-3 quarters as the client has mostly optimised its manufacturing footprint down to 7 sites in 2019, a 50% reduction from 14 sites that it had in 2016.

Valuation & Action: We downgrade Frencken to Neutral as we see limited upside. Our fair value of S\$0.93 is based on 10x FY20F earnings. Meanwhile, dividend yield has compressed to less than 3.0%.

Risks: Frencken's main business segments are cyclical in nature. A spending slowdown in its key business segments, namely semiconductor, automotive and analytical machines may impact margins and new orders. However, its track record has shown revenue resilience which may be due to the well-diversified mix of its business.

Revenue Trend by business segments

Figure 2: Revenue trend by business segments (Mechatronics Division)



Source: Company data, KGI Research

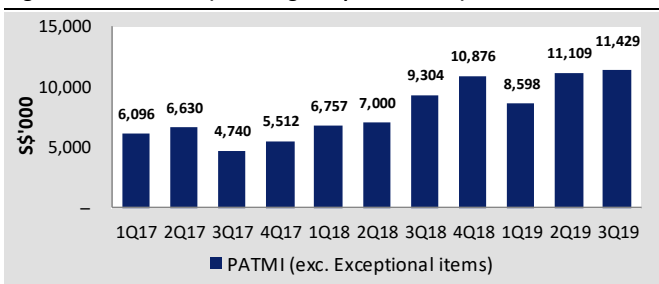
Diversified sales mix

Figure 3: Revenue breakdown (YoY and QoQ comparison)

Sales (S\$'000)	3Q 19	3Q 18	YoY (%)	2Q19	QoQ (%)
Semiconductor	33,578	30,469	10.2%	24,262	38.4%
Medical	21,256	20,990	1.3%	22,754	(6.6%)
Analytical	31,109	33,946	(8.4%)	35,541	(12.5%)
Industrial Automation	50,621	41,068	23.3%	46,111	9.8%
Others	4,495	4,829	(6.9%)	4,342	3.5%
Mechatronics Total	141,059	131,302	7.4%	133,010	6.1%
Automotive	22,212	23,804	(6.7%)	24,992	(11.1%)
Consumer & Industrial Elect.	4,822	5,441	(11.4%)	4,686	2.9%
Others	1,333	326	308.9%	1,150	15.9%
Tooling	1,057	2,968	(64.4%)	855	23.6%
IMS Total	29,424	32,539	(9.6%)	31,683	(7.1%)

Source: Company data, KGI Research

Figure 4: PATMI trend (excluding exceptional items)



Source: Company data, KGI Research

Riding on long-term trends in semiconductor and data storage.

1) Semiconductor. In its 3Q19 earnings call, ASML had guided for a stronger 4Q19 and expects 2019 to be another record year with around EUR11.7bn of sales, driven mainly by delivery of its Extreme Ultraviolet Lithography (EUV) systems. Demand for EUV has been stronger-than-expected, with logic order intake making up 73% of total value in 3Q19 system bookings, reflecting strong logic demand and confidence in the technology. This demand in turn is fuelled by end-market applications requiring high performance compute, specifically 5G and AI, as customers accelerate their 7 nanometre ramp up.

2) Industrial Automation. Seagate's current capex plans, which will be in the range of 6-8% of its revenues, will be to support its capacity expansion plan and prepare for the ramp up of its heat-assisted magnetic recording (HAMR) technology. Seagate is banking on HAMR to drive 20% CAGR growth in areal density over the next decade, and expects 20 terabyte HAMR drives by 2020. As for overall data centre spend, Seagate sees 2020 to be a stronger YoY year on higher volume demand.

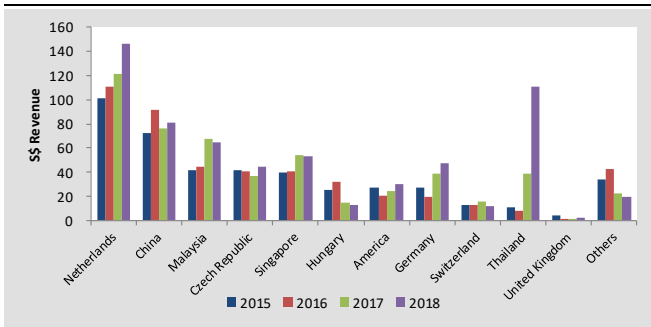
Figure 5: Company profile

Frencken Group Limited (Frencken) provides original equipment and integrated manufacturing solutions. The group has 17 operating sites across Asia, Europe and the USA and caters to multinational companies in the automotive, healthcare, industrial, life sciences and semiconductor industries. Revenue from Europe and Asia contributed to 42% and 53% of FY18 total sales, respectively.

Frencken was listed on the SGX in May 2005.

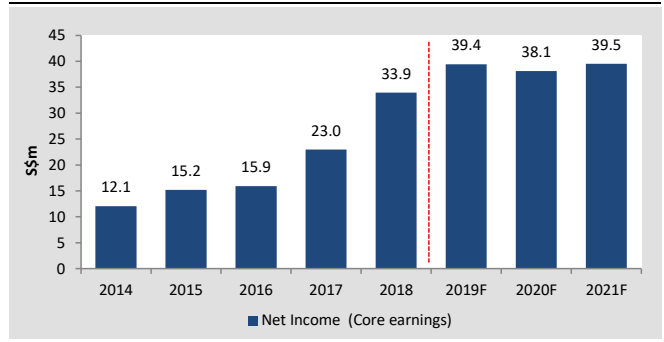
Source: KGI Research

Figure 7: Revenue breakdown by geography



Source: Company data, KGI Research

Figure 6: Core net earnings (excluding exceptional items)



Source: Company data, KGI Research

Figure 8: Frencken's clients include many multinational companies



Source: Company data, KGI Research

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Rating	Definition
Outperform (OP)	We take a positive view on the stock. The stock is expected to outperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
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