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**MAIN MARKET INDUSTRIAL PRODUCTS & SERVICES**

**16 March 2021**

# KELINGTON GROUP

**Initiation Coverage**

## BUY

| | |
|---|---|
| **Current Price** | **RM 1.92** |
| **Target Price** | **RM 2.22** |
| **Consensus Price** | **RM 2.24** |

**Stock Return Information**

| | |
|---|---|
| KLCI | 1,619.53 |
| Expected share price return (%) | 15.6 |
| Expected dividend return (%) | 1.0 |
| Expected total return (%) | 16.6 |

**Key Statistics**

| | |
|---|---|
| Shariah Compliant | YES |
| Bloomberg Ticker | KGRB MK |
| Masa Ticker / Stock Code | KGB/0151 |
| Shares Issued (m) | 630.0 |
| Market Capitalisation (RM'm) | 832 |
| 52 Week Hi/Lo Price (RM) | 2.70/0.59 |
| Avg Trading Volume (3-mth) | 3,801,413 |
| Est Free Float (%) | 57.6 |
| YTD Returns (%) | 15.4 |
| Beta (x) | 1.18 |

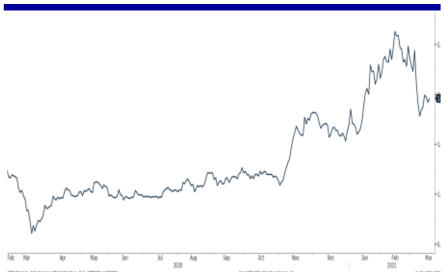
**Share Price Performance (%)**

| Price change | Absolute | Relative |
|---|---|---|
| 1 mth | -24.71 | -25.63 |
| 3 mth | 17.47 | 21.07 |
| 12 mth | 129.41 | 102.84 |

**Major Shareholders (%)**

| | |
|---|---|
| Palace Star | 21.1 |
| CIMB Principle Asset Manageme | 7.7 |

**1-Year Share Price Performance**



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# *Anticipated Robust Outlook*

**Kelington Group Bhd**'s (KGB) principle operations are: 1) engineering services for ultra high purity (UHP) gas and chemical delivery systems solutions, 2) pro engineering for mechanical and electrical systems, general contracting and construction services, and (3) supply a range of industrial and specialty gasses used by electronics, semiconductor, food processing, and oil and gas industries.

With a tender book of RM1.0b and on a back of a record orderbook win of RM490m in 2020, the group is poised to benefit from: 1) China's investment in the domestic wafer plants to curb its overreliance on foreign supply chain, and (2) accelerated CAPEX in the foundry industry arising from increase demand of electronic goods.

**Key downside risks** include slower-than-expected contract wins, potential extension or stricter lockdowns/work restrictions and delay in customer expansion plans. Meanwhile, **upside potentials** include higher than expected order replenishment and higher take up rate of liquid CO2 (LCO2).

**Investment merits** include firmer earnings growth potential, supported by increased job orders from the semiconductor industry and stable new income stream from LCO2 operations which could also help to shore up dividend prospects. KGB commissioned its first LCO2 plant at the end of 2019, trimming its dependence from its core engineering operations.

We initiate coverage with a by ascribing a target PER of 24x to our forecast CY22 EPS. We like KGB, **BUY recommendation and a TP of RM2.22** as they are a beneficiary of the strong semiconductor upcycle. Despite lofty valuation, we see it as justified, as we expect a longer upcycle driven by leading-edge technological advancement in consumer electronics, automotive, quantum computing and A.I that will permanently increase the demand for wafer plants.

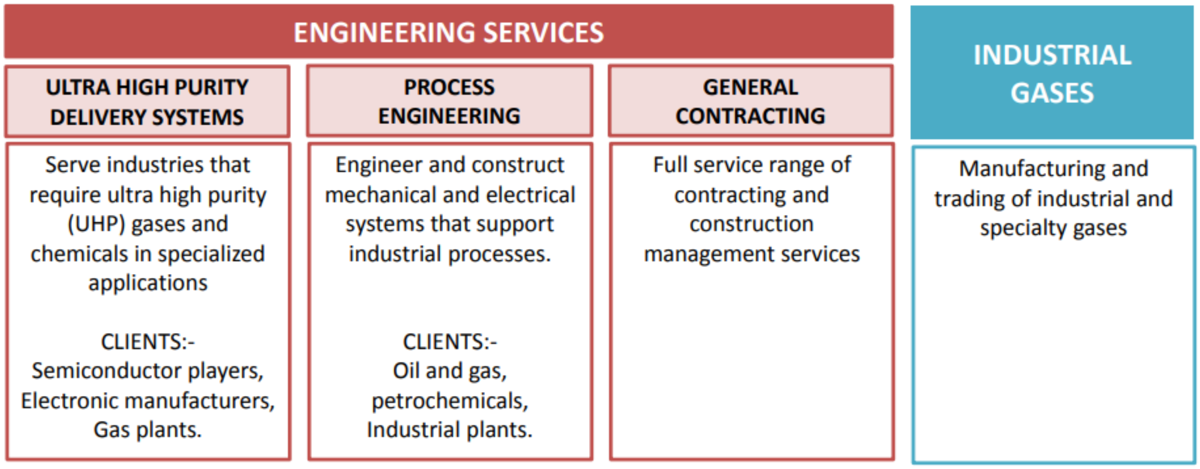
**Table 1: Financial highlights & earnings forecasts**

| FYE 31st Dec (RM m) | CY18 | CY19 | CY20 | CY21(F) | CY22(F) |
|---|---|---|---|---|---|
| Revenue | 350.0 | 379.8 | 389.8 | 483.0 | 561.1 |
| EBITDA | 28.4 | 36.7 | 23.6 | 47.7 | 51.4 |
| EBITDA Margin (%) | 8.1 | 9.7 | 6.0 | 9.9 | 9.2 |
| PATAMI | 18.6 | 24.4 | 17.1 | 31.0 | 36.8 |
| PATAMI Margin (%) | 5.3 | 6.4 | 4.4 | 6.4 | 6.6 |
| EPS (sen) | 4.5 | 5.9 | 4.1 | 7.5 | 8.9 |
| Earnings Growth (%) | 65.3 | 30.9 | (29.9) | 81.5 | 18.7 |
| PER (x) | 42.8 | 32.7 | 46.6 | 25.7 | 21.7 |
| DPS (sen) | 1.8 | 2.0 | 0.5 | 2.0 | 2.0 |
| Dividend Yield (%) | 0.9 | 1.0 | 0.3 | 1.0 | 1.0 |
| ROE (%) | 21.5 | 20.3 | 11.9 | 21.7 | 27.0 |
| ROA (%) | 10.3 | 10.4 | 5.7 | 11.2 | 13.5 |
| Net Gearing Ratio (%) | NET CASH | NET CASH | NET CASH | NET CASH | NET CASH |
| Price/Book Ratio (x) | 6.9 | 5.1 | 4.8 | 4.2 | 4.4 |

*Source: Company, Inter-Pacific Research*

**Company background**

**Illustration 1: Operating segments**




*Source: Company*

**UHP delivery systems (UHP)**

KGB's UHP delivery systems services include: 1) base build, and (2) hook up and maintenance. Base build is the initial construction/fabrication of the piping and interconnects the UHP delivery system. Hook up is the installation work for gas or chemical distribution throughout the manufacturing plant. The group has three UHP fabrication facilities located in Malaysia, Singapore and China. The group also provides gas detection, remote monitoring and exhaust system. **This segment contributes to 70% of KGB's CY19 revenue.**

**Processing engineering (PE)**

The group offers engineering and construction of mechanical systems that includes customised skid fabrications to large scale plant constructions across various gas and liquid delivery requirements outside of the scope of UHP, such as food, petrochemicals and industrial gas. **This segment represents 24% of KGB's CY19 revenue.**

**General contracting (GC)**

**Representing 5% of CY19 revenue**, KGB also provides civil works, clean room construction and solar installation.

**Industrial Gas**

The group distributes and supplies various range of industrial (nitrogen, hydrogen, carbon dioxide ($CO_2$), oxygen and specialty gases) used in the electronics, semiconductor, food processing, and oil and gas industries. The group owns a $LCO_2$ plant in Kerteh that has a daily production capacity of 150 tonnes. The $LCO_2$ is of food grade quality and it is sold domestically and exported overseas for food and beverage, and construction & fabrication industries. The manufacturing plant will acquire the $CO_2$ waste gas from Petronas Gas' Processing Plant under a 15-year supply agreement, signed in 2017. The plant commenced operation in 2H2019. The group also established downstream manufacturing of dry ice ($CO_2$ in solid form) in Bukit Jelutong in 2019. Key customers are AirAsia, Malindo Air, Baskin Robin, Brahim's and bereavement operators. The group in the midst of obtaining its Halal certification and it's expected to be certified by 4QCY21. The group has four skid tanks for the export market.

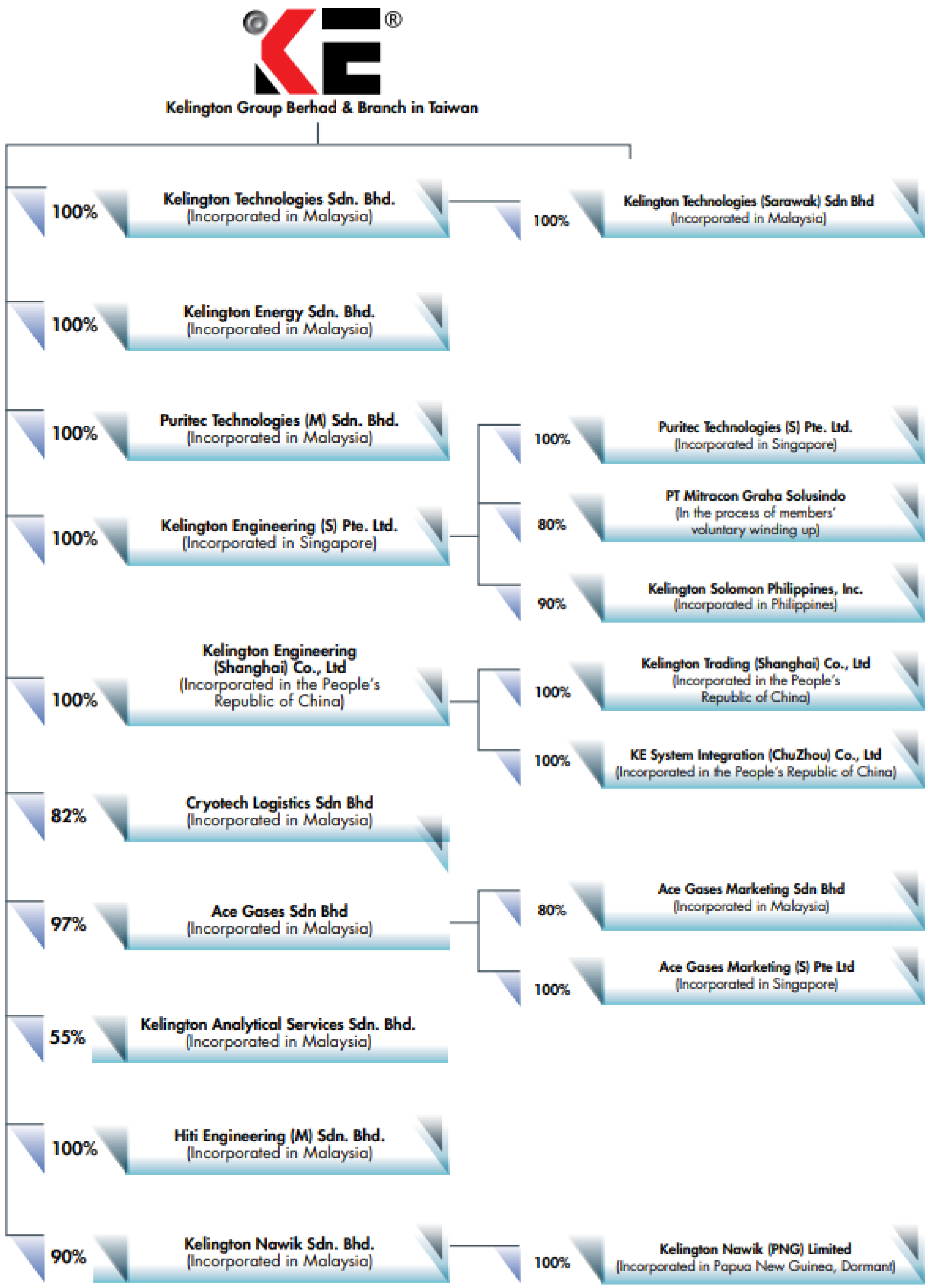
**Illustration 2: LCO2 plant in Kerteh**

*Source: Company*

**Illustration 3: Dry Ice plant in Bukit jelutong**

*Source: Company*

**Illustration 4: Organisation structure**

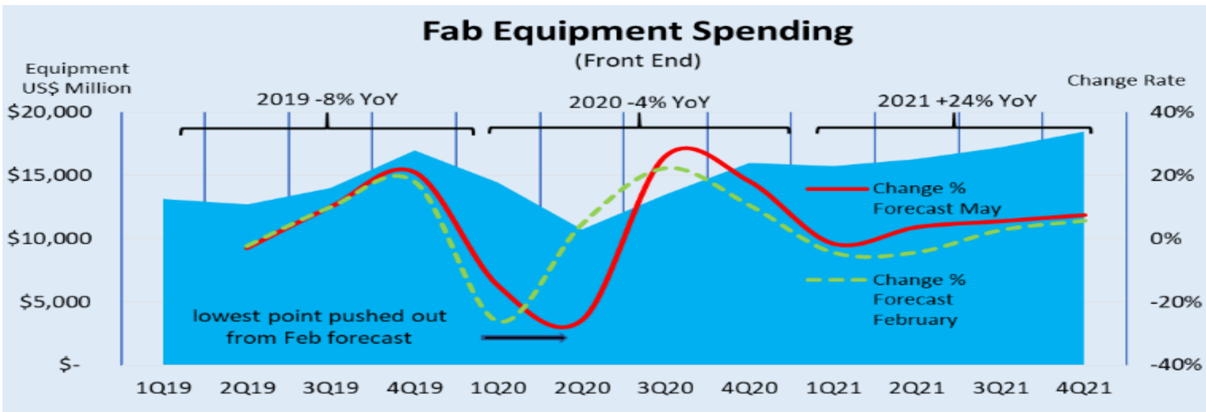



*Source: Company*

## Investment merits

**Proxy to semiconductor industry spending** KGB's key clients for UHP delivery system services are semiconductor & electronics manufactures. IC Insight - a leading semiconductor market research company, envisage a robust global fab equipment spending could reach $67.7b in CY21, up 24.0% Y-o-Y. The memory fabs segment may record $30.0b in equipment spending, while leading-edge logic and foundry is to record $29.0b in new investments.

**Illustration 5: Increasing semiconductor manufacturing activity**




*Source: IC Insight*

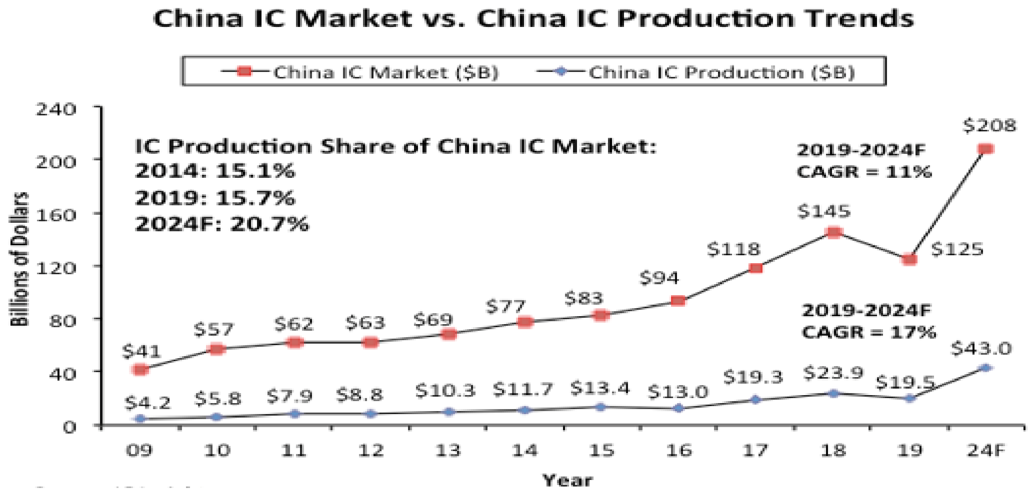
In the backdrop of rising technological tension, **China has pledged to spend $1.4t in 2020-2025 for investments in the semiconductor industry to raise self-sufficiency**. Yangtze Memory, China's top flash chip maker will invest $22.0b in the near future, while China's largest foundry plant, SMIC plans to invest $6.7b. To note, 25% of KGB's CY20 revenue came from SMIC. Aside from SMIC, other Chinese chipmarkers such as Yangtze Memory, CHangXin Memory, Nexchip, Tsinghua Unigroup and Slan Microelectornics have announced capacity expansion to meet the country's demand.

**Table 2: Chinese chipmakers' new fabs invement plans**

| Company | Product | Capacity (thousand/month) | 2020 1H | 2020 2H | 20201 1H | 20201 2H | 2022 -2024 |
|---|---|---|---|---|---|---|---|
| Yangtze Memory | 3D NAND | 200 | | | | | ✔ |
| ChangXin Memory | DRAM | 100 | | | | | ✔ |
| Nexchip | Foundry | 40 | | | | | ✔ |
| SMIC | Foundry, Discrete | 223 | ✔ | | ✔ | | ✔ |
| Tsinghua Unigroup | 3D, DRAM | 160 | | | ✔ | | ✔ |
| Silan Microelectronics | IGBT, MEMS | 80 | ✔ | | | | ✔ |

Source: Bloomberg, SEMI Engineering

**Illustration 6: Increasing semiconductor manufacturing activity**

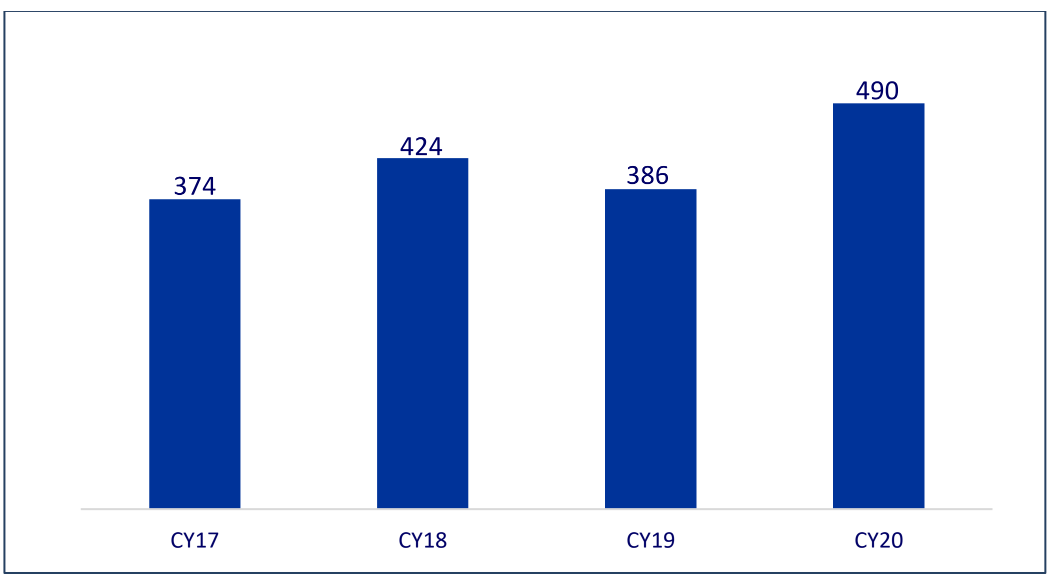



*Source: IC Insight*

**Growing order book that is at a record high.** KGB secured RM490m worth of new contracts in CY20, contributed by increased work orders from Micron and SMIC in the UHP segment and the processing engineering segment in Malaysia's petro & oleo chemical, oil & gas and industry. The group orderbook replenishment rate has been around 109%-to-136% from CY17-CY19.

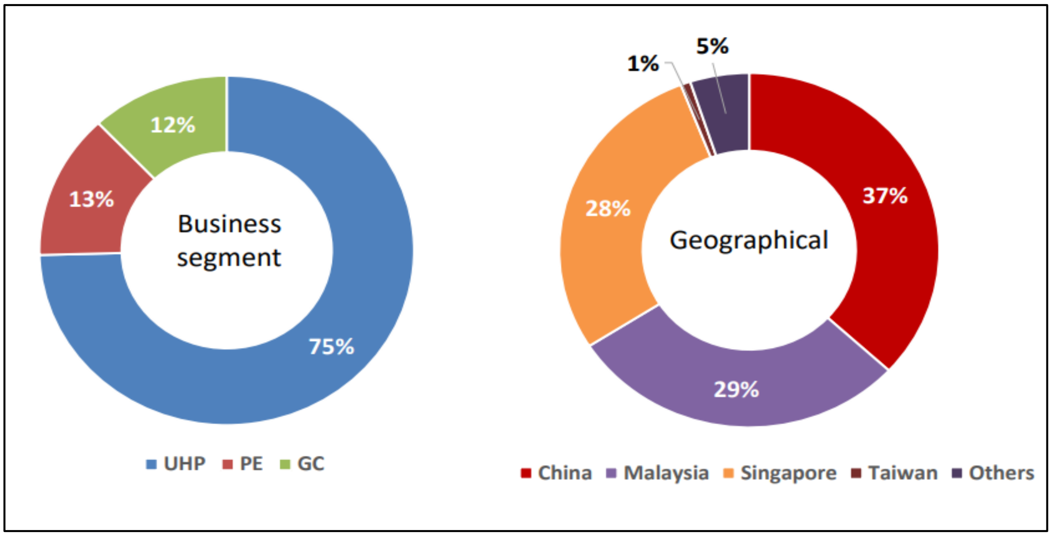
The group tender books stand at RM1.0b and we envisaged the UHP segment to be occupied with expansion jobs on the semiconductor industry and the processing engineering segment to bag more jobs within the petrolchemical industry due to rising demand for nitrile butadiene. Unprecedented demand from the pharmaceutical and sanitary care product has widened the manufacturing margin between oleochemicals and palm oil and this will bolster KGB's engineering jobs opportunities.

**Illustration 7: Order book win (RM m')**




*Source: Company*

**Illustration 8: Order book composition CY2020**




*Source: Company*

**GP margin expansion and recurring income** The group targets to expand its industrial gas division to represent one third of the group earnings in the midterm (2023). LCO2 operations commands higher GP margin (above 30% when operating at full capacity) than its incumbent businesses (15%-16%), that translates into higher profit margin and higher ROE.

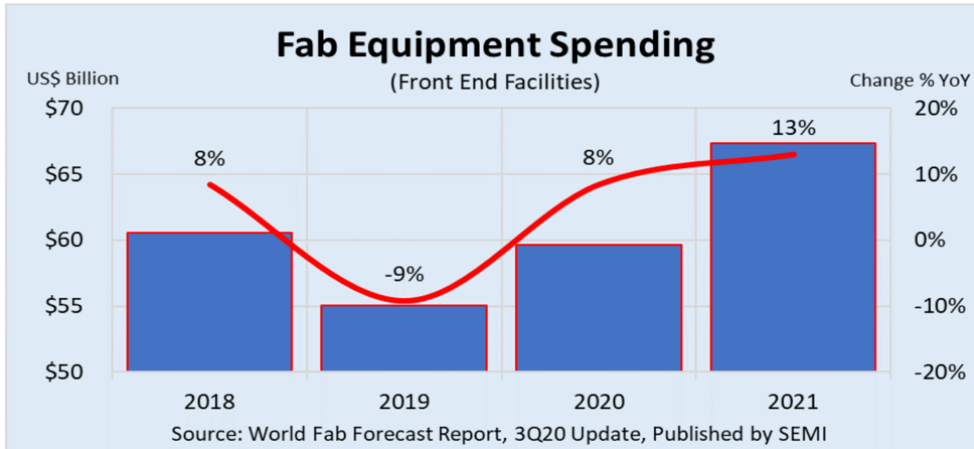
**Stable dividend pay-out** We view industrial gases are essential consumables with relatively inelastic demand. Its move to secure a reliable foothold in this segment is expected to provide a source of recurring income stream and provides an avenue for the group to ensure a steady dividend pay-out.

**Industry**

Leading industry researchers, SEMI and IC Insight forecast wafer fab equipment spending to increase 13.0% and 24.0% in 2021, led by investments in the logic semiconductor segment. The under investment in mature nodes, the demand for work from home electronics and improving visibility of emerging technology products (such as 5G, AI & Automotive) are the key demand drivers.

The Department of Statistics Malaysia estimates Malaysia GDP to grow by 6.8% and 4.8% in 2021 and 2022 respectively, driven by improved business & consumer confidence and boosted by higher export to China and regional neighbors. The gradual economic recovery will increase demand for PE works, general contract and industrial gases in due course and we believe this will fortify the group's future earnings growth prospects.

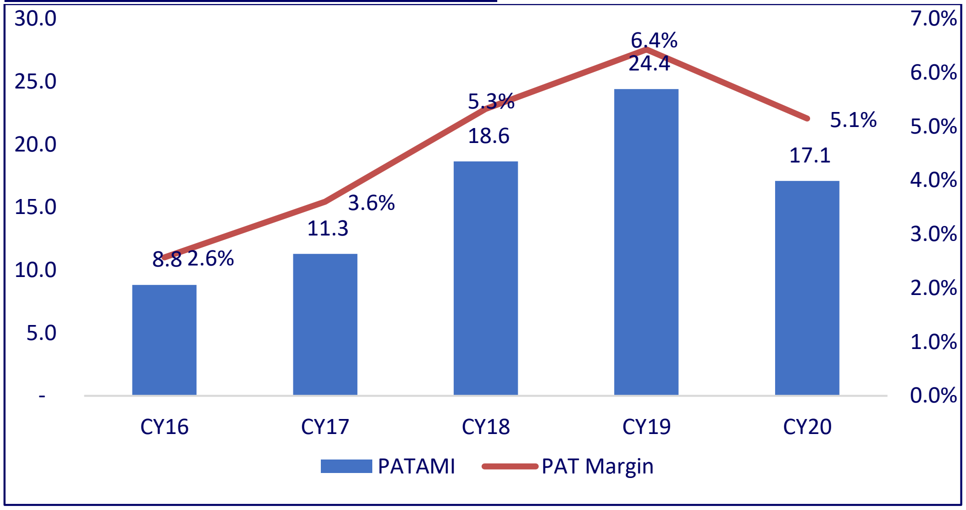
**Illustration 9: SEMI wafer fab equipment spending forecast**




*Source: SEMI*

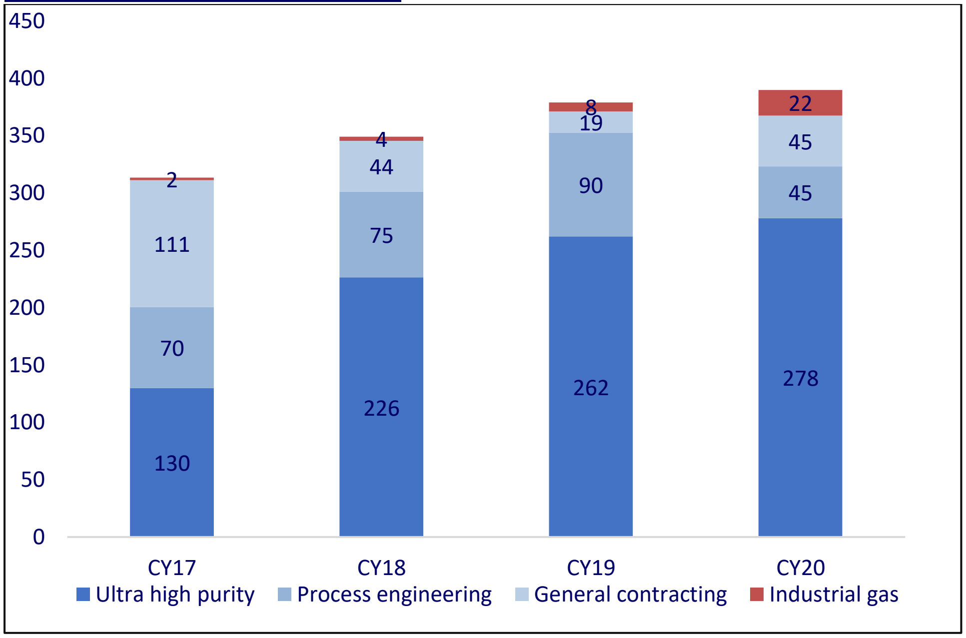
## Financials insights

**Illustration 11: Revenue and PATAMI margin**




*Source: Company*

**Illustration 12: Revenue breakdown**




*Source: Company*

Excluding the pandemic episode, the group's **PATAMI grew at CAGR of 28.3% during the CY16 to CY19 period**, while **PATAMI margin expanded to 6.4% in CY19 versus 2.6% in CY16**, backed by: 1) higher contract wins, and (2) execution of higher margin contract work (UHP delivery systems and process engineering). The majority of these works are awarded by two key clients that operates in the memory and logic industry.

Stringent operating procedures during the pandemic period have disrupted KGB's operations in China (1QCY20), Singapore (2QCY20) and Malaysia (2QCY20). CY20 earnings and PATMI margin dipped due to productivity losses and impairments (RM2.3m). However, the weaker results were buffered by the commencement of the LCO2 plant in late 2019, that boosted the industrial gas segment's revenue higher over the previous year (RM22m in CY20 vs. RM8.0m in CY19), and a tax refund from R&D incentive in China.

**Earnings forecast** We estimate earnings growth of +64%/+18% respectively in CY21/22, driven by: 1) larger orderbook replenishment of RM455m/RM540m in CY21/22, and 2) higher revenue contribution from LCO2 plant resulting in earnings and margin expansion. Lucrative tender book in the pipeline includes potential order wins in Singapore (Micron and GlobalFoundries) and China.

**Dry ice** The Malaysian government utilises deep freezers at the vaccination centers and the vaccine is prepacked with dry ice throughout the air freight. We view the earning upside is for dry ice operations are limited due to the low usage for Covid -19 vaccines domestically.

**Table 3: Financial insights**

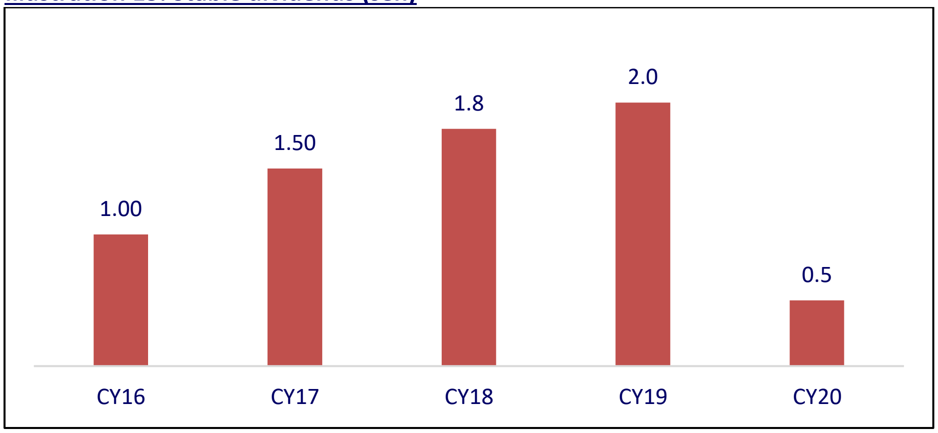
| FYE Dec | CY18 | CY19 | CY20 | CY21(F) | CY22(F) |
|---|---|---|---|---|---|
| Income statement (RM'm) | | | | | |
| Revenue | 350.0 | 379.8 | 389.8 | 483.0 | 561.1 |
| EBITDA | 28.4 | 36.7 | 23.6 | 43.7 | 46.4 |
| Depreciation and amortisation | 2.1 | 3.1 | 2.6 | 4.7 | 3.5 |
| Net interest (expenses)/income | (0.2) | (0.3) | (1.7) | (1.5) | (6.6) |
| Pre-tax profit | 25.0 | 31.6 | 20.1 | 37.5 | 44.5 |
| Tax | (6.7) | (7.7) | (2.8) | (9.0) | (10.7) |
| PATAMI | 18.6 | 24.4 | 17.1 | 28.0 | 33.0 |
| EPS | 4.5 | 5.9 | 4.1 | 6.7 | 8.0 |

| FYE Dec | CY18 | CY19 | CY20 | CY21(F) | CY22(F) |
|---|---|---|---|---|---|
| Balance Sheet (RM'm) | | | | | |
| Property, plant & Equipment | 24.7 | 53.0 | 59.7 | 62.0 | 65.5 |
| Other LT assets | 6.3 | 10.7 | 10.7 | 10.7 | 10.7 |
| Total cash and equivalents | 67.1 | 85.1 | 132.0 | 126.0 | 91.5 |
| Other ST assets | 145.3 | 154.4 | 148.3 | 167.4 | 194.7 |
| Total assets | 243.5 | 303.1 | 350.7 | 366.1 | 362.4 |
| ST borrowings | 15.6 | 12.1 | 25.3 | 30.0 | 30.0 |
| Other ST liabilities | 110.0 | 109.5 | 124.9 | 110.7 | 115.7 |
| LT borrowings | 1.5 | 23.3 | 30.0 | 35.0 | 35.0 |
| Other LT liabilities | 0.1 | 2.6 | 2.4 | 2.4 | 2.4 |
| Total liabilities | 127.3 | 147.5 | 182.6 | 178.1 | 183.1 |
| Share capital | 50.4 | 71.3 | 73.3 | 73.3 | 73.3 |
| Other equity and reserves | 65.8 | 84.3 | 94.9 | 114.7 | 106.1 |
| Total equity | 116.2 | 155.5 | 168.2 | 188.0 | 179.4 |
| Total equity and liabilities | 243.5 | 303.1 | 350.7 | 366.1 | 362.4 |

| FYE Dec | CY18 | CY19 | CY20 | CY21(F) | CY22(F) |
|---|---|---|---|---|---|
| Key metrics | | | | | |
| Revenue growth (%) | 11.7 | 8.5 | 2.6 | 23.9 | 16.2 |
| EBTIDA growth (%) | 47.5 | 29.2 | (35.7) | 85.6 | 6.2 |
| PATMI growth (%) | 65.3 | 30.9 | (29.9) | 63.7 | 18.0 |
| EBTIDA margin (%) | 8.1 | 9.7 | 6.0 | 9.1 | 8.3 |
| PATAMI margin (%) | 5.3 | 6.4 | 4.4 | 5.8 | 5.9 |
| Net gearing (x) | NET CASH | NET CASH | NET CASH | NET CASH | NET CASH |

*Source: Company, Inter-Pacific*

**Illustration 13: Stable dividends (sen)**




*Source: Company*

Taking into consideration of KGB’s dividend policy of 25% net profit payout, we estimate dividends of 2.0 sen per share for CY21/22 respectively and would translate to a 1.1%/1.1% dividend yield. We reckon the lower dividend payout in CY20 is due to the company efforts to conserve its war chest for tender deposits as UHP industry is poise to be busy and would require substantial working capital.

**Competition**

In the UHP segment, we reckon KGB is considered a preferred tier 1 engineering contractor given the notable clienteles on hand, despite stiff competition in Malaysia, Singapore and China. Air Liquid and Kinetics Process Systems are direct competitors to KGB in Malaysia's UHP industry, while Air Liquide is the main competitor in Singapore. In China, competitors are PNC Process System Co Ltd, Shanghai GenTech Co Ltd, Marketech and Kinetics.

For the LCO2 segment, Linde Malaysia is the incumbent and leading LCO2 and specialty gas supplier. KGB's strengths lie with its ability to: 1) lower equipment cost than it competitor (equipment from China) which allows them to be flexible with pricing, 2) being small enables them to serve customer better by being nimble and able to better meet customer demands, 3) ability to capture Malaysian market share by positioning itself as a secondary/supplementary CO2 supplier.

For the LCO2 export market, KGB currently supplies to the end users in the construction industry and aims to gradually grow its presence with their selected distributors and to cater to the food and beverage industry.

## Recommendation and Valuation

We arrived at a fair value of RM2.22, ascribed from a target PER of 24x to CY22(F) EPS. Our valuation basis and fair value is backed by:-

1) earnings prospects for the next five years are intact, driven by (a) China's commitment to build up its semiconductor supply chain, (b) permanent step of semiconductor content in automotive & consumer electronics, and (c) complemented by its LCO2 business

2) we envisaged a richer valuation to come, driven by the low interest environment and high valuation for companies that are similiarly tied to the strong semiconductor upcycle due to the wafer supply shortages. The shortages are enticing global foundries to expand capacity to meet automotive and telecommunication semiconductor demand and will also translate to higher demand for KGB's services

3) rich valuations are usually awarded to companies operating in high growth engineering industries such as solar installation services, where **Solarvest** is traded at forward PER range 12x-21x in 2020.

**Table 4: Valuation Matrix**

| | | | | CY22(F) EPS | | | |
|---|---|---|---|---|---|---|---|
| PER | -0.15 | -0.1 | -0.05 | 8.87 | 0.05 | 0.1 | 0.15 |
| 21x | 1.66 | 1.76 | 1.85 | **1.95** | 2.05 | 2.15 | 2.24 |
| 22x | 1.73 | 1.84 | 1.94 | **2.04** | 2.14 | 2.24 | 2.35 |
| 23x | 1.81 | 1.92 | 2.02 | **2.13** | 2.23 | 2.34 | 2.45 |
| 24x | 1.88 | 2.00 | 2.11 | **2.22** | 2.33 | 2.44 | 2.55 |
| 25x | 1.96 | 2.08 | 2.19 | **2.31** | 2.42 | 2.54 | 2.65 |
| 26x | 2.19 | 2.31 | 2.44 | **2.57** | 2.70 | 2.83 | 2.96 |
| 29x | 1.06 | 1.12 | 1.18 | **1.24** | 1.30 | 1.37 | 1.43 |

*Source: Inter-Pacific*

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Signed

Victor Wan Kum Seng
Head of Research
Inter-Pacific Research Sdn Bhd

## Ratings System

| Ratings: | Description: |
|---|---|
| BUY | Total return is expected to exceed 15% in the next 12 months |
| TRADING BUY | Total return is expected to exceed 10% in the next 3 months |
| NEUTRAL | Total return is expected to be between –15% to 15% in the next 12 months |
| SELL | Total return is expected to be below -15% in the next 12 months |
| TRADING SELL | Total return is expected to be below -10% in the next 3 months |
| NOT RATED | The stock is not within regular research coverage |

## Abbreviation

| Abbreviation | Definition |
|---|---|
| PER | Price Earnings Ratio |
| PEG | PER to Growth |
| EPS | Earnings per Share |
| FYE | Financial Year End |
| FY | Financial Year |
| CY | Calendar Year |
| MoM | Month-on-Month |
| QoQ | Quarter-on-Quarter |
| YoY | Year-on-Year |
| YTD | Year-to-Date |
| p.a. | Per Annum |
| DCF | Discounted Cash Flow |
| FCF | Free Cash Flow |
| NAV | Net Asset Value |

| Abbreviation | Definition |
|---|---|
| CAGR | Compounded Annual Growth Rate |
| CAPEX | Capital Expenditure |
| DPS | Dividend per Share |
| ROA | Return on Asset |
| ROE | Return on Equity |
| PBT | Profit Before Tax |
| PAT | Profit After Tax |
| EV | Enterprise Value |
| EBIT | Earnings Before Interest And Tax |
| EBITDA | EBIT Depreciation &Amortisation |
| WACC | Weighted Average Cost of Capital |
| NTA | Net Tangible Asset |
| BV | Book Value |



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