Frencken Group Ltd (FRKN SP)

Resilience and diversity

BUY for margin expansion potential

We see Frencken as a proxy to growth trends in 5G/AI, health and wellness and population aging through its blue-chip customers. In the short term, semiconductor equipment/analytical/automotive endmarkets, which form around 70% of sales, should provide cyclical resilience. Longer-term, we are excited by margin growth potential from deepening value-add with customers as Frencken launches a breadth of products in coming years. Maintain BUY with ROE-g/COE-g TP of SGD1.39 (1.6x FY21E P/B).

Deepening engagement with blue chip customers

In its mechatronics segment (c.80% of revenues), Frencken's marketleading customers include ASML, Seagate, Thermo Fisher and Philips. Mechatronics products tend to be critical, have demanding requirements, and Frencken is usually the sole source. Frencken is currently involved in a breadth of new products across semiconductor, analytical, medical and others slated for launch in coming years. As it provides greater design value-add, we believe margin expansion potential is currently underappreciated.

Around 70% of revenue in upswing/ recovery

We forecast earnings growth of 21% in FY21E - which we see underpinned by semiconductor equipment, analytical, and automotive end-markets, which we estimate account for around 70% of revenues. These segments are currently in various degrees of upswing/recovery. Balance sheet is clean with net cash to equity of around 8%.

Risks

The key risk to our view is prolonged economic uncertainties that may erode the resilience of Frencken's diversified revenue streams. Frencken indicated that the operating landscape remains challenging due to the negative effects of Covid-19.

FYE Dec (SGD m)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue	626	659	619	692	713
EBITDA	71	80	75	87	96
Core net profit	34	47	42	50	56
Core FDEPS (cts)	8.0	11.0	9.8	11.8	13.0
Core FDEPS growth(%)	46.3	36.2	(10.8)	20.8	10.4
Net DPS (cts)	2.1	3.0	2.9	3.6	3.9
Core FD P/E (x)	5.2	8.4	10.6	8.8	8.0
P/BV (x)	0.7	1.3	1.4	1.2	1.1
Net dividend yield (%)	5.1	3.2	2.8	3.4	3.8
ROAE (%)	11.7	15.1	13.5	14.7	14.7
ROAA (%)	7.7	9.6	8.2	9.1	9.4
EV/EBITDA (x)	2.5	4.0	4.8	3.8	3.5
Net gearing (%) (incl perps)	0.6	net cash	net cash	net cash	net cash
Consensus net profit	-	-	42	47	51
MKE vs. Consensus (%)	-	-	(1.2)	6.2	8.7

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BUY

Share Price	SGD 1.04
12m Price Target	SGD 1.39 (+37%)
Previous Price Target	SGD 1.39

Company Description

Frencken manufactures components and modules for various industries including semiconductor, life sciences, automotive and industrial automation.

Statistics

52w high/low (SGD)	1.24/0.48
3m avg turnover (USDm)	3.2
Free float (%)	59.8
Issued shares (m)	426
Market capitalisation	SGD443.5M
	USD330M
Major shareholders:	
GOOI FAMILY	9.4%
Micro Compact Sdn. Bhd.	6.2%
Precico Holdings Sdn. Bhd.	6.1%

Price Performance



	-1M	-3M	-12M
Absolute (%)	0	9	16
Relative to index (%)	(10)	(2)	33
Source: FactSet			

-Frencken Group - (LHS, SGD) ----- Frencken Group / Straits Times Index - (RHS, %)

Link to sector note:

ASEAN Technology - Riding a new wave; U/G to POSITIVE



Value Proposition

- Technology hardware manufacturer that specialises in complex components.
- High-mix, low-volume, high complexity for mechatronics segment.
- Customers are sticky, given: i) decades-long working relationships; ii) complementary competencies; and iii) mutual dependency (sole-source for some critical products).
- We expect Frencken to leverage its relationships with customers to introduce products with greater value-add, in turn driving margins further.

Diverse end markets with room for margin expansion



Financial Metrics

- Over the medium term, we expect earnings to be driven by revenue growth and margin optimisation through new products and improving efficiencies.
- Net cash balance sheet and strong cash flow should provide resilience amid economic uncertainties.
- Historically pays out 30% of earnings as dividends. We expect this trend to continue.



EPS, FCF per share and DPS

Price Drivers

Historical share price trend



- 1. 1Q17 core net profit doubled to SGD6.1m, driven by strength in semiconductor and analytical subdivisions.
- 2. General derating of the Singapore tech sector amid initial US-China tensions.
- 3. Reported FY18 core net profit of SGD34m (+47% YoY) on strength from industrial automation.
- Reported 3Q19 core net profit of SGD31m (+35%) on strength from industrial automation and semiconductor. General tech sector rerating amid initial signs of global semiconductor recovery.

Swing Factors

Upside

- Stronger-than-expected semiconductor and industrial automation contributions in FY20-21E.
- Robust margin accretion from new products and improving efficiencies.
- Improving institutional interest, which could help the stock rerate towards peers' valuations.

Downside

- Erosion in revenue resilience due to on-going economic weakness.
- Supply chain disruptions that impede Frencken's production ability and revenue recognition.
- Lower-than-expected dividend pay-out.

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Business Model & Industry Issues

- The nature of Frencken's business in the electronics and automotive manufacturing supply chains exposes it to risks including environmental, workplace safety, and conflict of interest. Frencken has not faced any fines or non-monetary sanctions pertaining environmental nor socioeconomic laws and regulations in 2019.
- From an environment perspective, Frencken's Eco-PVD offering can be seen as a more environmentally friendly approach for automotive coating. While Frencken does not use recycled materials currently, it may do so in the future subject to customers' requirements.
- From a governance and socioeconomic perspective, Frencken is adopting industry best practices, including those set by customers, as these facilitate smooth business.

Material E issues

- Environmental risks Frencken's production process involves non-renewable materials and waste generation. Non-compliance of rules and laws may severely impact the environment of local communities.
- In 2019, Frencken had zero fines and non-monetary sanctions for non-compliance with environmental laws and/or regulations.
- Areas for potential improvement include i) increased use of recycled materials, contingent on customer approval;
 ii) increased efficiency of water and electric usage.
- Opportunities Frencken's proprietary eco-PVD coating technology is more environmentally friendly than traditional PVD methods. Frencken is optimistic of longterm prospects for this offering.

Material S issues

- Employee health and safety risks. Frencken benchmarks its occupational safety and health practices against industry best practices. E.g. the Bangi (Malaysia) plant is in compliance with Agilent Supplier Environmental, Health and Safety and Social Responsibility guidelines.
- No Covid-19 cases as at May-20. Employee safety remains of paramount importance for Frencken with proper mitigation measures implemented.
- In 2019, Frencken's injury rate was 0.078%.
- Employees underwent an average of 8.9 hours of training in 2019 across topics such as environmental management, health and safety, HR, and quality management.
- Male employees account for 70.9% of the workforce. Socioeconomic risks. To ensure smooth business operations, Frencken i) adheres to all applicable laws and regulations and ii) upholds strong ethical standards. This safeguards trust with stakeholders and avoids liability due to non-compliance.

Key G metrics and issues

- Board consists of six directors, of whom one is an executive director (CEO), one is a non-executive, nonindependent chairman, and four are independent (67%). All directors are male.
- The nominating, audit and remuneration committees are chaired by independent directors.
- Chairman Mr. Gooi Soon Chai's deemed stake in the company is c.22%.
- Three independent directors have served more than nine years from date of appointments. Frencken states that their independence is not in any way affected by their length of service.
- Professional background of independent directors includes law, accounting, consultancy and electronics engineering.
- Key management/ directors' compensation accounted for 3.6%/1.2% of total employee compensation in 2019. (2018: 3.2%/ 1%)
- Related-party transactions were immaterial (<1% of profit).
- Auditor is Deloitte & Touche LLP which was appointed in 2014.
- Former non-independent non-executive chairman Mr. Larry Low resigned in 2016 and pared his stake from 8.14% to 4.74% in 2018. Mr. Low is the father of fugitive Jho Low. However, this development has no impact to the governance nor operations of the company as current management and board are independent of Mr. Low.

FYE 31 Dec	FY18A	FY19A	FY20E	FY21E	FY22E
Key Metrics					
P/E (reported) (x)	7.0	6.4	10.6	8.8	7.9
Core P/E (x)	5.2	8.4	10.6	8.8	7.9
Core FD P/E (x)	5.2	8.4	10.6	8.8	8.0
P/BV (x)	0.7	1.3	1.4	1.2	1.1
P/NTA (x)	0.7	1.3	1.4	1.2	1.1
Net dividend yield (%)	5.1	3.2	2.8	3.4	3.8
FCF yield (%)	2.8	22.4	6.6	8.7	4.0
EV/EBITDA (x)	2.5	4.0	4.8	3.8	3.5
EV/EBIT (x)	4.0	5.5	6.7	5.2	4.7
INCOME STATEMENT (SGD m)					
Revenue	625.8	659.2	619.0	691.9	713.0
Gross profit	101.7	111.4	103.9	119.4	125.8
EBITDA	71.4	80.5	75.2	87.4	95.6
Depreciation	(26.4)	(21.1)	(21.2)	(22.4)	(23.9)
Amortisation	0.0	0.0	0.0	0.0	(23.9)
EBIT	45.1	59.4	54.0	65.0	71.6
Net interest income / (exp)	(1.0)	(1.3)	(0.9)	(0.9)	(0.9)
Associates & JV	0.0	0.0	0.0	0.0	0.0
Exceptionals Other protections	(3.9) 0.0	(4.2) 0.0	0.0 0.0	0.0 0.0	0.0 0.0
Other pretax income					
Pretax profit	40.2	53.9	53.1	64.1	70.7
Income tax	(9.8)	(11.3)	(11.1)	(13.5)	(14.8)
Minorities	(0.3)	(0.2)	(0.2)	(0.2)	(0.2)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	30.0	42.4	41.7	50.4	55.7
Core net profit	33.9	46.5	41.7	50.4	55.7
BALANCE SHEET (SGD m)					
Cash & Short Term Investments	67.1	122.4	138.8	162.1	162.9
Accounts receivable	115.9	97.6	102.5	113.6	120.8
Inventory	144.6	140.7	127.5	161.1	160.6
Property, Plant & Equip (net)	97.4	92.1	95.9	98.4	99.5
Intangible assets	19.7	17.5	17.5	17.5	17.5
Investment in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other assets	19.1	35.9	35.9	35.9	35.9
Total assets	463.7	506.2	518.1	588.7	597.2
ST interest bearing debt	67.5	53.1	53.1	53.1	53.1
Accounts payable	79.2	87.8	70.3	105.4	74.8
LT interest bearing debt	1.2	0.2	0.2	0.2	0.2
Other liabilities	48.0	67.0	67.0	67.0	67.0
Total Liabilities	196.2	208.0	190.5	225.7	195.0
Shareholders Equity	264.9	295.4	324.6	359.9	398.8
Minority Interest	2.6	2.8	3.0	3.2	3.4
Total shareholder equity	267.5	298.2	327.6	363.1	402.2
Total liabilities and equity	463.7	506.2	518.1	588.7	597.2
CASH FLOW (SGD m)			:		
Pretax profit	40.2	53.9	53.1	64.1	70.7
Depreciation & amortisation	26.4	21.1	21.2	22.4	23.9
Adj net interest (income)/exp	0.0	0.0	0.0	0.0	0.0
Change in working capital	(28.3)	33.6	(9.2)	(9.7)	(37.3)
Cash taxes paid	(7.4)	(9.4)	(11.1)	(13.5)	(14.8)
Other operating cash flow	3.9	4.2	0.0	0.0	0.0
Cash flow from operations	34.7	103.4	54.0	63.4	42.5
Capex	(29.8)	(15.8)	(25.0)	(25.0)	(25.0)
Free cash flow	4.9	87.5	29.0	38.4	17.5
Dividends paid	(10.1)	(9.1)	(12.5)	(15.1)	(16.7)
Equity raised / (purchased)	0.9	0.6	0.0	0.0	0.0
Change in Debt	5.1	(15.5)	0.0	0.0	0.0
Other invest/financing cash flow	(1.1)	6.4	0.0	0.0	0.0
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Effect of excit rate changes	0.0	0.0		0.0	0.0

Key Ratios Growth ratios (%) Revenue growth EBITDA growth EBIT growth Pretax growth Reported net profit growth Core net profit growth Profitability ratios (%)	21.5 16.5 48.8 0.2 (9.3) 47.7	5.3 12.6 31.7 34.2 41.1 37.1	(6.1) (6.6) (9.0) (1.5) (1.5) (10.3)	11.8 16.3 20.3 20.7 20.8	3.0 9.3 10.2 10.4
Revenue growth EBITDA growth EBIT growth Pretax growth Reported net profit growth Core net profit growth	16.5 48.8 0.2 (9.3)	12.6 31.7 34.2 41.1	(6.6) (9.0) (1.5) (1.5)	16.3 20.3 20.7	9.3 10.2
EBITDA growth EBIT growth Pretax growth Reported net profit growth Core net profit growth	16.5 48.8 0.2 (9.3)	12.6 31.7 34.2 41.1	(6.6) (9.0) (1.5) (1.5)	16.3 20.3 20.7	9.3 10.2
EBIT growth Pretax growth Reported net profit growth Core net profit growth	48.8 0.2 (9.3)	31.7 34.2 41.1	(9.0) (1.5) (1.5)	20.3 20.7	10.2
Pretax growth Reported net profit growth Core net profit growth	0.2 (9.3)	34.2 41.1	(1.5) (1.5)	20.7	
Reported net profit growth Core net profit growth	(9.3)	41.1	(1.5)		10.4
Core net profit growth	. ,		. ,	20.8	
	47.7	37.1	(10.3)		10.4
Profitability ratios (%)				20.8	10.4
EBITDA margin	11.4	12.2	12.1	12.6	13.4
EBIT margin	7.2	9.0	8.7	9.4	10.0
Pretax profit margin	6.4	8.2	8.6	9.3	9.9
Payout ratio	29.9	30.0	30.0	30.0	30.0
DuPont analysis					
Net profit margin (%)	4.8	6.4	6.7	7.3	7.8
Revenue/Assets (x)	1.3	1.3	1.2	1.2	1.2
Assets/Equity (x)	1.8	1.7	1.6	1.6	1.5
ROAE (%)	11.7	15.1	13.5	14.7	14.7
ROAA (%)	7.7	9.6	8.2	9.1	9.4
Liquidity & Efficiency					
Cash conversion cycle	101.9	97.2	96.7	91.7	102.6
Days receivable outstanding	62.2	58.3	58.2	56.2	59.2
Days inventory outstanding	88.2	93.8	93.7	90.7	98.6
Days payables outstanding	48.5	54.9	55.2	55.2	55.2
Dividend cover (x)	3.3	3.3	3.3	3.3	3.3
Current ratio (x)	1.8	2.0	2.2	2.2	2.6
Leverage & Expense Analysis					
Asset/Liability (x)	2.4	2.4	2.7	2.6	3.1
Net gearing (%) (incl perps)	0.6	net cash	net cash	net cash	net cash
Net gearing (%) (excl. perps)	0.6	net cash	net cash	net cash	net cash
Net interest cover (x)	45.2	45.9	59.7	71.8	79.1
Debt/EBITDA (x)	1.0	0.7	0.7	0.6	0.6
Capex/revenue (%)	4.8	2.4	4.0	3.6	3.5
Net debt/ (net cash)	1.6	(69.2)	(85.6)	(108.9)	(109.7)

Source: Company; Maybank

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Historical recommendations and target price: Frencken Group Ltd (FRKN SP)



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