

Frencken Group Ltd (FRKN SP)

Supply chain challenges hurt margins

1Q22 miss due to lower-than-expected margins

1Q22 PATMI of SGD12.8m (-12.6% YoY) fell short of our and consensus estimates, reaching only c.19% of our full-year forecast, due to lower-than-expected margins. We cut F22-23E earnings by 18-21% to factor in higher costs. Lowering TP by 27% to SGD1.80 as we reduce our target multiple from 15.5x FY22E P/E to 14x amid cost headwinds (SG peers trading at 13.7x). Retain BUY as we believe Frencken's multi-year growth story of value-add via new products across several customers is intact.

Semicon and analytical drove 1Q22 sales growth

1Q22 revenue rose 9.3% YoY to SGD198.3m, on the back of growth from semicon (+15.5% YoY), analytical (+16.7% YoY) and industrial (+8.7% YoY). Automotive fell 11% YoY due to chip shortages. Net margin fell 1.6ppt YoY to 6.5% due to higher costs (e.g. materials, freight and energy etc.) as well as higher depreciation following SGD28.6m capex in FY21.

Impact of supply chain pressure might ease in 2H22

Cost pressures from supply chain challenges may potentially ease in 2H22 as Frencken may be able to pass on higher costs on to customers. Some of Frencken's automotive customers in China were unable to take delivery of products due to disruptions caused by Covid-19. Easing of these should help revenue and margins too. Notwithstanding, we assume FY22E net margin of 6.3% (vs. 6.5% in 4Q21-1Q22) to account for risks of worsening further supply chain challenges.

Maintains optimistic outlook

Management maintains an optimistic outlook for long-term growth due to value-add and strong execution with existing blue-chip customers. For instance, the acquisition of Avimac provides Frencken with large-format machining capacity and capability, and it is an important enabler for the full system assembly for an equipment that is now in new product introduction phase (Frencken has traditionally worked with components and modules). Frencken expects 1H22 semiconductor and analytical segments to post higher revenue HoH. It expects automotive to show marginal improvement HoH, industrial automation to be stable HoH, and medical to be lower HoH. Key risk remains further supply chain pressure.

FYE Dec (SGD m)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue	621	767	873	918	977
EBITDA	80	95	91	106	123
Core net profit	49	59	55	64	77
Core FDEPS (cts)	11.5	13.7	12.8	15.0	17.9
Core FDEPS growth(%)	4.8	19.8	(6.7)	16.6	20.0
Net DPS (cts)	3.4	4.1	3.9	4.5	5.4
Core FD P/E (x)	11.5	14.3	9.8	8.4	7.0
P/BV (x)	1.7	2.2	1.3	1.2	1.0
Net dividend yield (%)	2.6	2.1	3.1	3.6	4.3
ROAE (%)	13.6	16.5	13.9	14.6	15.8
ROAA (%)	9.2	9.4	7.8	8.4	9.4
EV/EBITDA (x)	5.7	7.9	4.7	3.8	3.3
Net gearing (%) (incl perps)	net cash	net cash	net cash	net cash	net cash
Consensus net profit	-	-	67	76	83
MKE vs. Consensus (%)	-	-	(18.1)	(15.3)	(6.9)

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BUY

Share Price	SGD 1.26
12m Price Target	SGD 1.80 (+45%)
Previous Price Target	SGD 2.47

Company Description

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

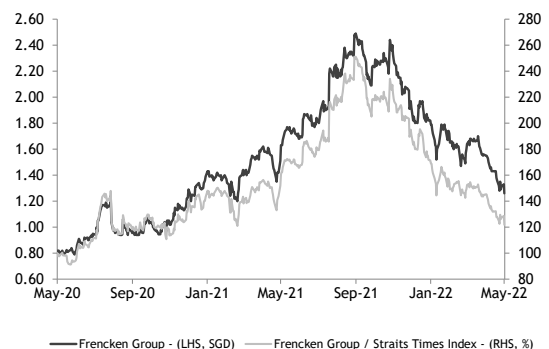
Statistics

52w high/low (SGD)	2.49/1.26
3m avg turnover (USDm)	4.6
Free float (%)	59.8
Issued shares (m)	426
Market capitalisation	SGD536.9M USD387M

Major shareholders:

Micro Compact Sdn. Bhd.	6.2%
Precico Holdings Sdn. Bhd.	6.1%
GOOI FAMILY	5.8%

Price Performance



	-1M	-3M	-12M
Absolute (%)	(19)	(24)	(23)
Relative to index (%)	(16)	(18)	(24)

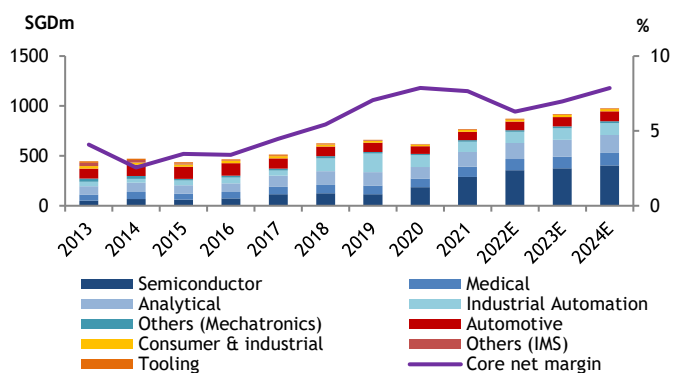
Source: FactSet

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Tear Sheet Insert

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

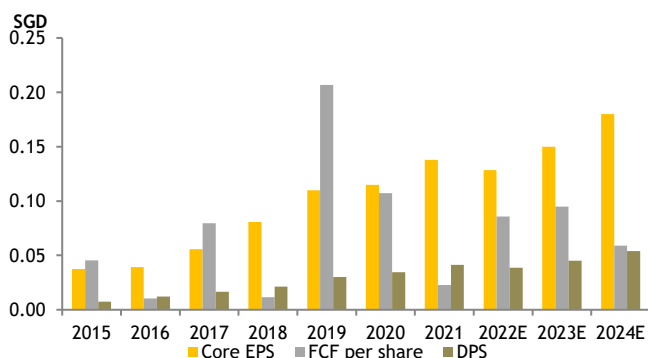


Source: Company

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.

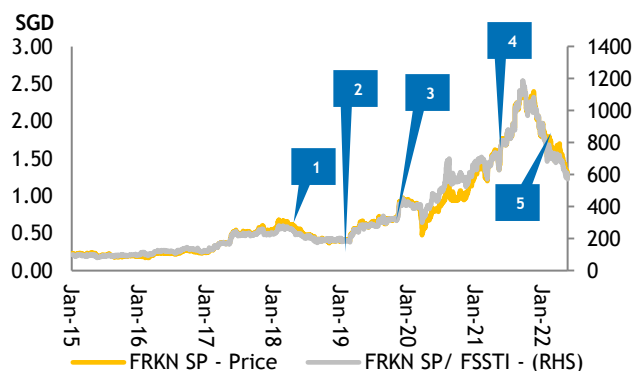
EPS, FCF per share and DPS



Source: Company, Maybank IBG Research

Price Drivers

Historical share price trend



Source: Company, Maybank IBG Research

1. General derating of the Singapore tech sector amid initial US-China tensions.
2. Reported FY18 core net profit of SGD34m (+47% YoY) on strength from industrial automation.
3. 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.
4. Frencken's semiconductor segment is beneficiary of chip shortages
5. Tech sector derating drove share price lower; 1Q22 net profit fell 12.6% YoY on margin pressures amid inflation and other supply chain challenges

Swing Factors

Upside

- Stronger-than-expected semiconductor and industrial automation contributions.
- 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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Risk Rating & Score ¹	na
Score Momentum ²	na
Last Updated	na
Controversy Score ³	na

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 2021.
- 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 2021, 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 long-term 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.
- Employee safety remains of paramount importance for Frencken with proper mitigation measures implemented.
- In 2021, Frencken’s injury rate was 0%. (2019: 0.15%).
- Employees underwent an average of 1.2-17 hours of training in 2021 across technical, occupational health and safety and strategic topics.
- Male employees account for 66% 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, non-independent 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 3.4%/1.4% of total employee compensation in 2021. (2019: 3.8%/ 1.3%).
- 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.

¹**Risk Rating & Score** - derived by Sustainalytics and assesses the company’s exposure to unmanaged ESG risks. Scores range between 0 - 50 in order of increasing severity with low/high scores & ratings representing negligible/significant risk to the company’s enterprise value, respectively, from ESG-driven financial impacts. ²**Score Momentum** - indicates changes to the company’s score since the last update - a **negative** integer indicates a company’s improving risk score; a **positive** integer indicates a deterioration. ³**Controversy Score** - reported periodically by Sustainalytics in the event of material ESG-related incident(s), with the impact severity scores of these events ranging from Category 0-5 (0 - no reports; 1 - negligible risks; ...; 5 - poses serious risks & indicative of potential structural deficiencies at the company).

Fig 1: Forecast changes

	FY22E			FY23E		
	New	Old	Chg (%)	New	Old	Chg (%)
Revenue (SGDm)	873.0	873.0	0.0	918.0	918.0	0.0
Gross profit (SGDm)	134.4	151.9	-11.5	148.4	164.9	-10.0
EBIT (SGDm)	67.1	84.3	-20.4	80.0	96.5	-17.1
EBITDA (SGDm)	89.9	107.0	-16.0	106.0	122.5	-13.5
Core net profit (SGDm)	54.9	69.3	-20.8	64.0	77.7	-17.6
EPS (SGD)	0.13	0.16	-20.8	0.15	0.18	-17.6
			Chg (ppt)			Chg (ppt)
Gross material margin	15.4%	17.4%	-2.0	16.2%	18.0%	-1.8
SGA as % of sales	8.2%	8.2%	0.0	7.9%	7.9%	0.0

Source: Maybank IBG Research

Fig 2: 1Q22 summary

FYE Dec	1Q22	1Q21	4Q21	YoY Chg	QoQ Chg	FYE	1Q22 vs. FYE
	SGDm	SGDm	SGDm	(%)	(%)	SGDm	(%)
Revenue	198.4	181.5	195.3	9.3	1.6	873.0	22.7
Gross profit	30.5	31.3	30.0	-2.4	1.7	151.9	20.1
Core PATMI	12.8	14.7	12.8	-12.6	0.4	69.3	18.5
				Change (ppt)			
Gross margin	17.3%	17.2%	15.4%	0.1	1.9		
Net margin	6.5%	8.1%	6.5%	-1.6	-0.1		

Source: Company, Maybank IBG Research

FYE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Key Metrics					
P/E (reported) (x)	9.1	13.2	9.8	8.4	7.0
Core P/E (x)	11.4	14.3	9.8	8.4	7.0
Core FD P/E (x)	11.5	14.3	9.8	8.4	7.0
P/BV (x)	1.7	2.2	1.3	1.2	1.0
P/NTA (x)	1.7	2.2	1.3	1.2	1.0
Net dividend yield (%)	2.6	2.1	3.1	3.6	4.3
FCF yield (%)	8.1	1.0	6.8	7.5	4.7
EV/EBITDA (x)	5.7	7.9	4.7	3.8	3.3
EV/EBIT (x)	7.7	10.4	6.3	5.1	4.2
INCOME STATEMENT (SGD m)					
Revenue	620.6	767.1	873.0	918.0	976.6
EBITDA	80.1	94.9	91.3	106.0	123.2
Depreciation	(21.1)	(23.0)	(24.2)	(26.0)	(27.8)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	58.9	71.9	67.1	80.0	95.4
Net interest income / (exp)	(0.8)	(1.4)	(1.4)	(1.4)	(1.4)
Associates & JV	0.0	0.0	0.0	0.0	0.0
Exceptionals	(6.2)	0.0	0.0	0.0	0.0
Other pretax income	0.0	0.0	0.0	0.0	0.0
Pretax profit	51.9	70.5	65.7	78.6	94.0
Income tax	(8.8)	(11.4)	(10.6)	(13.4)	(16.0)
Minorities	(0.2)	(0.4)	(0.2)	(1.2)	(1.2)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	42.8	58.7	54.9	64.0	76.8
Core net profit	49.1	58.7	54.9	64.0	76.8
BALANCE SHEET (SGD m)					
Cash & Short Term Investments	174.5	192.6	212.7	234.0	236.2
Accounts receivable	98.7	123.3	130.2	171.6	149.5
Inventory	143.2	203.1	221.9	199.8	243.5
Property, Plant & Equip (net)	99.8	110.8	102.6	127.6	152.6
Intangible assets	11.7	19.5	19.5	19.5	19.5
Investment in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other assets	36.0	38.9	38.9	38.9	38.9
Total assets	563.8	688.1	725.8	791.4	840.2
ST interest bearing debt	67.3	95.6	95.6	95.6	95.6
Accounts payable	80.1	121.9	120.9	140.5	134.4
LT interest bearing debt	0.0	1.6	1.6	1.6	1.6
Other liabilities	80.0	90.0	90.0	90.0	90.0
Total Liabilities	227.5	309.1	308.2	327.7	321.6
Shareholders Equity	334.0	376.2	414.6	459.4	513.1
Minority Interest	2.3	2.9	3.1	4.3	5.5
Total shareholder equity	336.3	379.0	417.6	463.6	518.6
Total liabilities and equity	563.8	688.1	725.8	791.4	840.2
CASH FLOW (SGD m)					
Pretax profit	51.9	70.5	65.7	78.6	94.0
Depreciation & amortisation	21.1	23.0	24.2	26.0	27.8
Adj net interest (income)/exp	0.0	0.0	0.0	0.0	0.0
Change in working capital	1.1	(34.7)	(26.7)	0.3	(27.8)
Cash taxes paid	(5.9)	(16.2)	(10.6)	(13.4)	(16.0)
Other operating cash flow	6.2	0.0	0.0	0.0	0.0
Cash flow from operations	74.4	42.6	52.6	91.5	78.0
Capex	(28.9)	(33.9)	(16.1)	(51.0)	(52.8)
Free cash flow	45.5	8.7	36.6	40.5	25.2
Dividends paid	(12.8)	(17.6)	(16.5)	(19.2)	(23.0)
Equity raised / (purchased)	0.8	0.1	0.0	0.0	0.0
Change in Debt	14.1	29.9	0.0	0.0	0.0
Other invest/financing cash flow	5.9	(3.5)	0.0	0.0	0.0
Effect of exch rate changes	(0.3)	0.0	0.0	0.0	0.0
Net cash flow	53.3	17.6	20.1	21.3	2.2

FYE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Key Ratios					
Growth ratios (%)					
Revenue growth	(5.8)	23.6	13.8	5.1	6.4
EBITDA growth	(0.5)	18.5	(3.7)	16.0	16.2
EBIT growth	(0.7)	22.1	(6.7)	19.1	19.3
Pretax growth	(3.8)	36.0	(6.8)	19.5	19.6
Reported net profit growth	1.1	37.1	(6.6)	16.6	20.0
Core net profit growth	5.4	19.7	(6.6)	16.6	20.0
Profitability ratios (%)					
EBITDA margin	12.9	12.4	10.5	11.5	12.6
EBIT margin	9.5	9.4	7.7	8.7	9.8
Pretax profit margin	8.4	9.2	7.5	8.6	9.6
Payout ratio	34.2	30.0	30.0	30.0	30.0
DuPont analysis					
Net profit margin (%)	6.9	7.7	6.3	7.0	7.9
Revenue/Assets (x)	1.1	1.1	1.2	1.2	1.2
Assets/Equity (x)	1.7	1.8	1.8	1.7	1.6
ROAE (%)	13.6	16.5	13.9	14.6	15.8
ROAA (%)	9.2	9.4	7.8	8.4	9.4
Liquidity & Efficiency					
Cash conversion cycle	97.5	92.8	96.7	96.7	96.7
Days receivable outstanding	56.9	52.1	52.3	59.2	59.2
Days inventory outstanding	99.2	97.7	103.6	98.6	98.6
Days payables outstanding	58.7	57.0	59.2	61.2	61.2
Dividend cover (x)	2.9	3.3	3.3	3.3	3.3
Current ratio (x)	2.0	1.9	2.0	2.0	2.1
Leverage & Expense Analysis					
Asset/Liability (x)	2.5	2.2	2.4	2.4	2.6
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)	70.3	51.3	47.8	57.0	68.0
Debt/EBITDA (x)	0.8	1.0	1.1	0.9	0.8
Capex/revenue (%)	4.7	4.4	1.8	5.6	5.4
Net debt/ (net cash)	(107.1)	(95.4)	(115.5)	(136.8)	(138.9)

Source: Company; Maybank IBG Research

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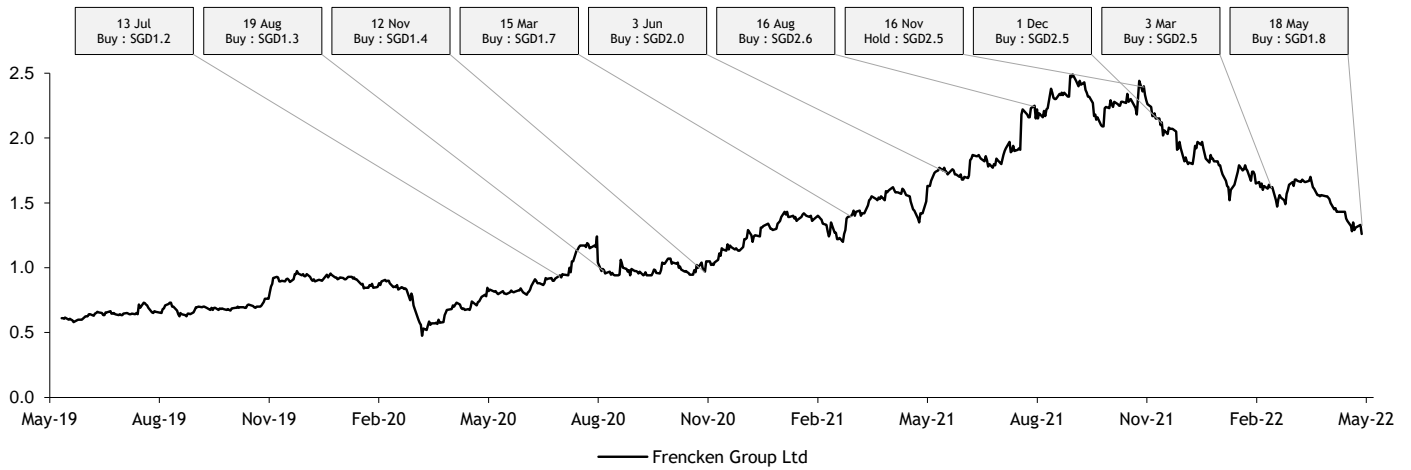
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