1 March 2021

Construction & Engineering | Industrial

Kelington Group (KGRB MK)

Sell (from Neutral)

4Q20 Earnings Boosted By Tax Refund; D/G SELL

Target Price (Return):	MYR2.11 (-10.6%)
Price:	MYR2.36
Market Cap:	USD187m
Avg Daily Turnover (MYR/USD)	6.12m/1.51m

- **D/G SELL from Neutral, new MYR2.11 DCF-derived TP from MYR2.00, 11% downside, c.1% yield.** FY20 core earnings beat expectations, helped by a tax refund from China in 4Q20. While we remain upbeat on its earnings prospects – backed by a MYR358m outstanding orderbook and 2-year 17% EPS CAGR – the share price has exceeded our TP (+40% YTD), with FY21 implied PER of 28x near +3SD of the historical mean. Its strong affiliation to the tech cycle is acknowledged, with the caveat being its business' contractual nature, whereby a discount is still warranted.
- **Boosted by tax incentives.** Kelington's MYR10.2m 4Q20 core earnings (+7% YoY, 45% QoQ) made up 47% of FY20's MYR21.7m core earnings (-7% YoY), beating our and Street's estimates at 126% and 142%. In deriving our core net profit, we excluded trade receivable impairments and losses on contract assets, and writebacks on impairment losses on trade receivables, among others, totalling MYR4.5m. We note that there was a tax refund in China, relating to research and development incentives from Kelington Engineering Shanghai for FY18 and FY19, bringing 4Q20's effective tax rate or ETR to -11% vs our 24% forecast.
- **Results review.** 4Q20's MYR130m revenue was up 16% YoY (+32% QoQ) on a larger orderbook base, with traditional businesses making up 95%. However, Adjusted EBITDA margins narrowed to 8.2% (-3.4ppts YoY, -3.8ppts QoQ) on higher general contracting jobs, which typically carry lower margins (see Figure 3 for segmental revenue breakdown), and higher costs from the delay of certain projects. FY20 also saw Adjusted EBITDA margins narrowing 0.9ppts after incurring unavoidable direct costs, and facing longer project timelines due to the additional SOP measures across key markers. This was partially cushioned by the MYR3.8m wage subsidy received in FY20. On the industrial gas front, 2H20 revenue made up 64% of FY20's segment revenue on the normalisation of business activities.
- **Forecast.** Our FY21F-22F earnings are adjusted by -1.2%/0.3% after we updated the financial statements. We believe FY21 earnings growth will be driven by the larger MYR358m outstanding orderbook carried forward, and ramping up of utilisation for its industrial gas business upon successfully penetrating the F&B segment. As such, we reduce our risk premium to 5.01% from 5.51% to factor in lower earnings risk, and the broad-based recovery of business activities following mass vaccinations.
- **Risks:** Weaker-than expected orders/earnings/margins, resumption of movement restrictions, and management execution. Upside risks: Stronger contract replenishment, faster-than-expected liquid carbon dioxide (LCO$_2$ demand recovery, and subsiding COVID-19 risks.

Forecasts and Valuation	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Total turnover (MYRm)	380	390	523	544	563
Recurring net profit (MYRm)	23	22	27	30	32
Recurring net profit growth (%)	20.3	(7.3)	23.1	11.6	7.7
Recurring P/E (x)	31.30	33.78	27.44	24.59	22.83
P/B (x)	4.7	4.4	3.9	3.5	3.2
P/CF (x)	37.15	17.38	na	23.35	21.48
Dividend Yield (%)	0.8	0.6	0.9	1.0	1.1
EV/EBITDA (x)	18.45	23.57	15.99	14.15	12.99
Return on average equity (%)	18.0	10.6	15.1	15.1	14.6
Net debt to equity (%)	net cash	net cash	net cash	net cash	net cash

Source: Company data, RHB

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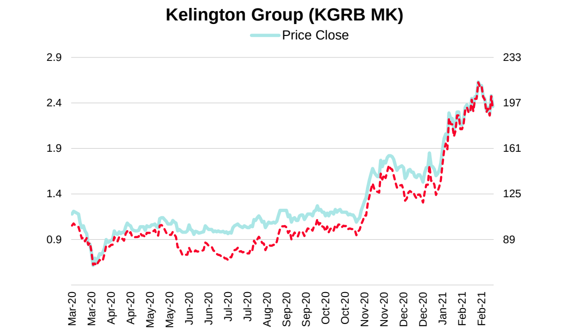
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	39.6	9.8	35.6	103.4	87.3
Relative	42.6	9.6	37.7	101.6	81.8
52-wk Price low/high (MYR)					0.62 – 2.63



Source: Bloomberg

Overall ESG Score: 2.8 (out of 4)

E: Good
KGB is committed to preserving the environment through various practices such as reducing electricity and water consumption. It is also managing its usage of materials to reduce material waste. However, KGB lacks environmental statistics for pollution and waste management.

S: Good
Apart from up-to-standard health & safety policies, we see active community engagements and efforts to uplift employee relations. KGB is focused on attracting and retaining talent, and helping employees develop their skills to drive further success.

G: Moderate
Ir. Raymond Gan is chairman and also Group CEO. The board does not utilise independent sources to identify the appointment of directors, which could limit operational checks and balances. KGB engages a third party investor relations outfit to facilitate communication with the investment community, with periodic meetings held.

Note:
Small cap stocks are defined as companies with a market capitalisation of less than USD1bn.

Financial Exhibits

Asia
Malaysia
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Sell

Valuation basis

DCF methodology (WACC : 7.1%, TG: 1.5%)

Key drivers

i. Stellar growth of the semiconductor industry in China;
ii. Growing outstanding orderbook;
iii. New LCO_2 business.

Key risks

Key downside risks include:
i. Slower-than-expected orders;
ii. Margin weakness;
iii. Execution.

Upside risks include:
i. Contract replenishment exceeding expectations;
ii. Faster-than-expected recovery in demand for LCO_2;
iii. COVID-19 subsiding.

Company Profile

KGB is involved in ultra-high purity (UHP) delivery systems, process engineering and general contracting. The company commenced maiden production of LCO_2 in 4Q19.

Financial summary (MYR)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Recurring EPS	0.08	0.07	0.09	0.10	0.10
DPS	0.02	0.01	0.02	0.02	0.03
BVPS	0.50	0.54	0.60	0.67	0.75
Return on average equity (%)	18.0	10.6	15.1	15.1	14.6

Valuation metrics	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Recurring P/E (x)	31.30	33.78	27.44	24.59	22.83
P/B (x)	4.7	4.4	3.9	3.5	3.2
FCF Yield (%)	(1.9)	4.7	(1.6)	3.6	4.0
Dividend Yield (%)	0.8	0.6	0.9	1.0	1.1
EV/EBITDA (x)	18.45	23.57	15.99	14.15	12.99
EV/EBIT (x)	20.12	28.92	17.50	15.39	14.09

Income statement (MYRm)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Total turnover	380	390	523	544	563
Gross profit	64	54	80	86	90
EBITDA	37	28	42	46	48
Depreciation and amortisation	(3)	(5)	(4)	(4)	(4)
Operating profit	34	23	38	42	45
Net interest	(1)	(3)	(3)	(3)	(2)
Pre-tax profit	32	20	35	39	42
Taxation	(8)	(3)	(8)	(9)	(10)
Reported net profit	24	17	27	30	32
Recurring net profit	23	22	27	30	32

Cash flow (MYRm)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Change in working capital	(8.5)	18.4	(37.2)	(2.2)	(1.9)
Cash flow from operations	19.7	42.1	(6.8)	31.3	34.1
Capex	(33.5)	(7.7)	(5.0)	(5.0)	(5.0)
Cash flow from investing activities	(35.2)	(7.9)	(7.0)	(5.0)	(5.0)
Dividends paid	(8.1)	(4.8)	0.0	(6.7)	(7.4)
Cash flow from financing activities	33.9	13.2	0.0	(6.7)	(32.4)
Cash at beginning of period	67.1	85.1	132.0	118.2	137.9
Net change in cash	18.4	47.5	(13.8)	19.7	(3.4)
Ending balance cash	84.8	132.0	118.2	137.9	134.5

Balance sheet (MYRm)	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Total cash and equivalents	85	132	118	138	135
Tangible fixed assets	53	60	61	62	64
Total assets	303	351	386	412	415
Short-term debt	12	25	25	25	25
Total long-term debt	23	30	30	30	5
Total liabilities	148	183	200	204	182
Total equity	156	168	186	209	233
Total liabilities & equity	303	351	386	412	415

Key metrics	Dec-19	Dec-20	Dec-21F	Dec-22F	Dec-23F
Revenue growth (%)	8.5	2.6	34.3	3.9	3.5
Recurrent EPS growth (%)	20.3	(7.3)	23.1	11.6	7.7
Gross margin (%)	16.7	13.9	15.4	15.8	16.0
Operating EBITDA margin (%)	9.7	7.1	8.0	8.5	8.6
Net profit margin (%)	6.4	4.4	5.1	5.5	5.7
Dividend payout ratio (%)	22.9	25.0	25.0	25.0	25.0
Capex/sales (%)	8.8	2.0	1.0	0.9	0.9
Interest cover (x)	25.9	8.7	12.7	14.4	19.7

Source: Company data, RHB

Results At A Glance

Figure 1: KGB's FY20 results

FYE Dec (MYRm)	4Q19	3Q20	4Q20	QoQ (%)	YoY (%)	FY19	FY20	YoY (%)	Comments
Revenue	111.2	98.3	129.5	32%	16%	379.8	389.8	3%	Gradual reopening of the economy
Adj. EBITDA	12.9	11.3	10.6	-6%	-17%	34.0	31.2	-8%	
Adj. EBITDA margin (%)	*11.6%*	*12%*	*8.2%*			*8.9%*	*8.0%*		
Other income	0.6	1.8	2.0	11%	201%	5.3	7.4	42%	YoY FY20 increase was mainly due to wage subsidies totaling MYR3.8m
Finance costs	(0.3)	(0.7)	(0.7)	6%	-89%	(1.3)	(2.6)	-99%	
Pretax profit	10.4	7.2	6.8	-5%	-34%	31.6	20.1	-36%	
Pretax margin (%)	9.3%	7.3%	5.2%			8%	5%		
Tax	(2.5)	(2.2)	0.8	136%	132%	(7.7)	(2.8)	63%	
Effective tax rate (%)	24%	31%	-11%			24%	14%		4Q20 saw a tax refund relating to R&D incentives in China
Minority interest	(0.3)	0.1	0.1	-27%	117%	(0.5)	0.1		
Net profit	8.2	4.9	7.5	53%	-8%	24.4	17.1	-30%	
Core profit	9.5	7.0	10.2	45%	7%	23.4	21.7	-7%	Ahead of expectations
Core net margin (%)	*9%*	*7%*	*8%*			*6.2%*	*5.6%*		

Source: RHB

Figure 2: Revenue by geography

FYE Dec (MYRm)	4Q19	3Q20	4Q20	QoQ (%)	YoY (%)	FY19	FY20	YoY (%)
Malaysia	22.8	31.5	48.0	52%	110%	89.3	118.2	32%
China	22.8	35.0	44.7	28%	96%	99.6	124.7	25%
Taiwan	1.7	5.4	3.7	-32%	114%	8.5	14.8	73%
Singapore	60.6	24.1	32.5	35%	-46%	177.6	127.4	-28%
Indonesia	0.4	0.1	0.3	533%	-21%	1.4	0.7	-49%
Total revenue	**111.3**	**98.3**	**129.5**	**32%**	**16%**	**379.9**	**389.8**	**3%**

Source: RHB

Figure 3: Segmental revenue

FYE Dec (MYRm)	4Q19	3Q20	4Q20	QoQ (%)	YoY (%)	FY19	FY20	YoY (%)
Ultra high purity	90.2	70.1	81.8	17%	-9%	262.9	278.1	6%
Process engineering	14.7	9.3	18.5	98%	26%	90.4	45.1	-50%
General contracting	2.4	11.6	22.3	93%	828%	18.6	44.5	139%
Industrial gases	4.1	7.2	6.9	-5%	69%	8.0	22.1	178%
Total revenue	**111.3**	**98.3**	**129.5**	**32%**	**16%**	**379.9**	**389.8**	**3%**

Figure 4: KGB's corroborative DCF valuation

FYE Dec (MYRm)	FY22F	FY23F	FY24F	FY25F	FY26F	FY27F	FY28F	FY29F	FY30F	FY31F
EBIT	42.3	44.6	46.7	46.4	47.7	49.1	50.1	51.5	53.0	54.6
EBIT*(1-tax rate)	32.1	33.9	35.5	35.2	36.2	37.3	38.0	39.2	40.3	41.5
Add: D&A	3.7	3.8	3.8	3.9	4.0	4.0	4.1	4.1	4.2	4.2
Less: WC investments (WC Inv)	-2.2	-1.9	-1.8	-1.4	-1.5	-1.5	-1.4	-1.6	-1.7	-1.7
Less: Fixed investments (FC Inv)	-5	-5	-5	-5	-5	-5	-5	-5	-5.0	-4.2
FCFF	**28.58**	**30.81**	**32.53**	**32.73**	**33.74**	**34.78**	**35.78**	**36.67**	**37.82**	**39.78**
Disc. FCFF	**26.06**	**25.62**	**24.67**	**22.63**	**21.27**	**20.00**	**18.76**	**17.53**	**16.49**	**15.81**
Terminal value at T=10	722									
PV of terminal value	364									
NPV	209									
Enterprise value of firm	573									
Add net cash	82									
Equity value of firm	655						**WACC**			
Equity value per share (MYR)	**2.11**			**TG**	5.1%	6.1%	7.1%	8.1%	9.1%	
Implied 2021F P/E (x)	25			0.5%	2.65	2.21	1.92	1.72	1.57	
				1.0%	2.87	2.35	2.01	1.78	1.61	
Rf	2.9%			1.5%	3.14	2.51	2.11	1.85	1.66	
Beta (x)	1.2			2.0%	3.51	2.71	2.23	1.92	1.71	
Risk premium	5.01%			2.5%	4.03	2.96	2.38	2.02	1.77	
Rm	7.9%									
TG (%)	1.5%									
CoE	8.8%									
CoD	2.4%									
Tax rate	24.0%									
WACC	7.1%									

Source: Company data, RHB

Figure 5: KGB is trading at +3SD to its 12-month forward earnings 5-year mean

Source: Bloomberg, RHB

Recommendation Chart

Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2021-01-20	Neutral	2.00	2.29
2020-11-25	Neutral	1.62	1.76
2020-11-17	Neutral	1.55	1.64
2020-08-13	Neutral	1.14	1.10
2020-06-05	Neutral	1.01	0.98
2020-05-19	Neutral	1.16	1.14
2020-03-13	Buy	1.32	0.97
2020-02-27	Buy	1.43	1.26
2020-02-09	Buy	1.45	1.24
2019-11-20	Buy	1.55	1.35
2019-09-20	Buy	1.58	1.32
2019-05-21	Buy	1.63	1.24
2019-02-27	Buy	1.52	1.24

Source: RHB, Bloomberg

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Trading Buy:	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain
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Take Profit:	Target price has been attained. Look to accumulate at lower levels
Sell:	Share price may fall by more than 10% over the next 12 months
Not Rated:	Stock is not within regular research coverage

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