

Frencken Group Ltd (FRKN SP)

Challenging outlook; D/G to HOLD

Lowering TP to SGD1.05 from SGD1.80

Tech stocks globally are still undergoing a de-rating and with a potential recession looming, we are mindful demand might suddenly taper off unexpectedly. As a result, we cut our FY22-23E earnings by 2-14% to factor in slower growth across certain segments and reduce our target multiple from 14x to 8.5x and downgrade Frencken from BUY to HOLD with a lower TP of SGD1.05 due to the muted macro outlook. We also transfer coverage to Jarick Seet.

Semi-con will still drive growth in 2H22

We expect the semi-con segment to continue to be one of the main drivers for 2H22E, along with the medical, analytical and life sciences segment. Automotive should also see a revival in 2H22 as compared to 1H22. However, industrial automation will continue to decline as its major customer in the hard disk space has still not ramped up production for its new product. In addition, we think there is risk its semi-con segment, which enjoyed robust growth for the past few years, could potentially see growth tapering off, especially if the world enters into a recession.

Gradual margin recovery likely

Frencken suffered lower margins in 1H22 due to a rise in raw material prices as well as higher labour and production costs. It has managed to renegotiate better pricing terms for the newer contracts and as a result should enjoy better margins in 2H22E. However, the recovery of margins will be gradual as some of its existing contracts are still based on the older lower prices.

Risk demand may drop unexpectedly

We feel that the outlook for Frencken is quite muted as compared to some of the other tech stocks in Singapore. As Frencken's factories are largely based in Europe, it may suffer an unexpected drop in demand with a recession looming. As a result, its robust pipeline of orders may suffer a setback as other competitors did in the past.

FYE Dec (SGD m)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue	621	767	832	857	882
EBITDA	80	95	90	95	100
Core net profit	49	59	54	55	58
Core FDEPS (cts)	11.5	13.7	12.5	12.8	13.5
Core FDEPS growth(%)	4.8	19.8	(8.8)	2.3	5.5
Net DPS (cts)	3.4	4.1	3.8	3.9	4.1
Core FD P/E (x)	11.5	14.3	7.9	7.7	7.3
P/BV (x)	1.7	2.2	1.0	0.9	0.9
Net dividend yield (%)	2.6	2.1	3.8	3.9	4.1
ROAE (%)	13.6	16.5	13.6	12.7	12.2
ROAA (%)	9.2	9.4	7.7	7.3	7.3
EV/EBITDA (x)	5.7	7.9	3.4	3.0	2.9
Net gearing (%) (incl perps)	net cash	net cash	net cash	net cash	net cash
Consensus net profit	-	-	56	66	73
MKE vs. Consensus (%)	-	-	(4.2)	(16.2)	(21.2)

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HOLD

[Prior:BUY]

Share Price	SGD 0.99
12m Price Target	SGD 1.05 (+10%)
Previous Price Target	SGD 1.80

Company Description

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

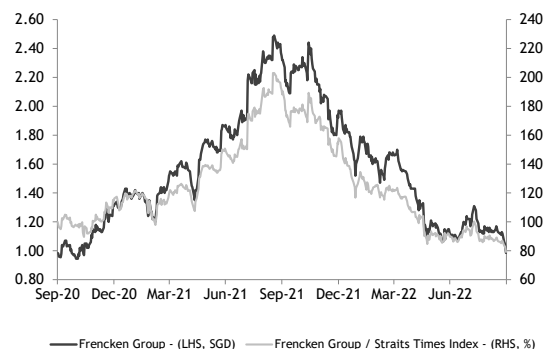
Statistics

52w high/low (SGD)	2.44/0.99
3m avg turnover (USDm)	2.3
Free float (%)	59.8
Issued shares (m)	426
Market capitalisation	SGD419.7M USD292M

Major shareholders:

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

Price Performance



	-1M	-3M	-12M
Absolute (%)	(14)	(13)	(58)
Relative to index (%)	(11)	(12)	(59)

Source: FactSet

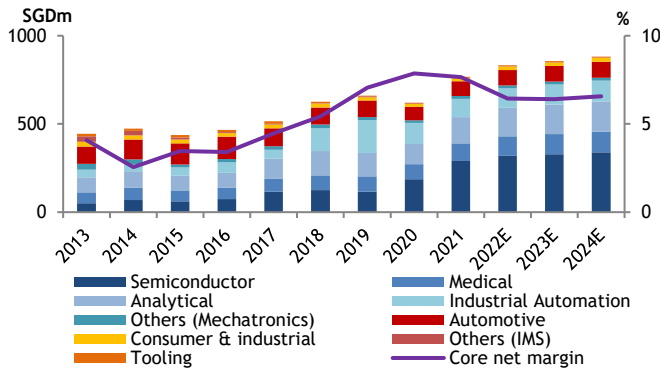
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Tear Sheet Insert

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.

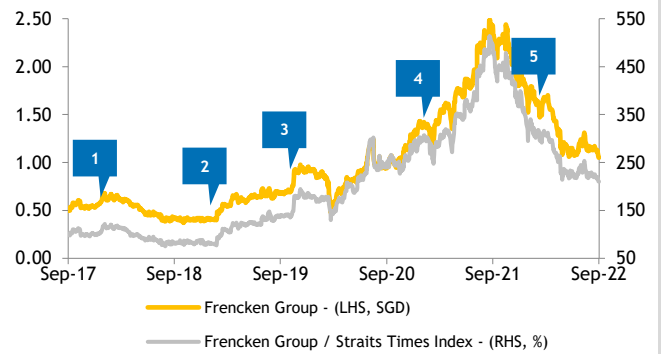
Diverse end markets



Source: Company

Price Drivers

Historical share price trend



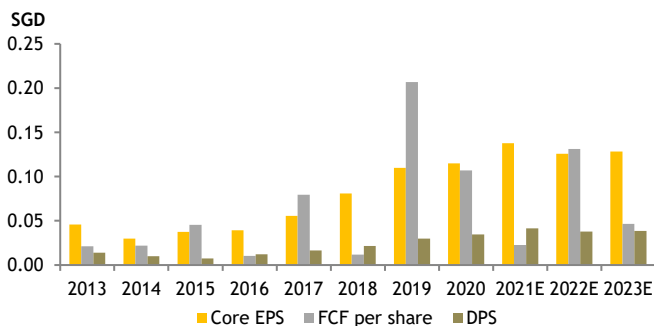
Source: Company, Maybank IBG Research

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

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

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 re-rate towards peers’ valuations.

Downside

- Drop in demand.
- 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).

FYE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Key Metrics					
P/E (reported) (x)	9.1	13.2	7.8	7.7	7.3
Core P/E (x)	11.4	14.3	7.8	7.7	7.3
Core FD P/E (x)	11.5	14.3	7.9	7.7	7.3
P/BV (x)	1.7	2.2	1.0	0.9	0.9
P/NTA (x)	1.7	2.2	1.0	0.9	0.9
Net dividend yield (%)	2.6	2.1	3.8	3.9	4.1
FCF yield (%)	8.1	1.0	8.6	9.0	4.6
EV/EBITDA (x)	5.7	7.9	3.4	3.0	2.9
EV/EBIT (x)	7.7	10.4	4.7	4.2	4.0

INCOME STATEMENT (SGD m)

Revenue	620.6	767.1	832.4	856.8	881.9
EBITDA	80.1	94.9	89.9	95.0	100.4
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	65.6	68.9	72.5
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	64.2	67.5	71.1
Income tax	(8.8)	(11.4)	(10.4)	(11.5)	(12.1)
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	53.6	54.9	57.8
Core net profit	49.1	58.7	53.6	54.9	57.8

BALANCE SHEET (SGD m)

Cash & Short Term Investments	174.5	192.6	212.7	234.0	236.2
Accounts receivable	98.7	123.3	118.4	163.3	126.7
Inventory	143.2	203.1	201.2	194.7	212.5
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	58.7	40.9	54.0
Total assets	563.8	688.1	713.2	779.9	801.4
ST interest bearing debt	67.3	95.6	95.6	95.6	95.6
Accounts payable	80.1	121.9	109.2	136.3	116.1
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	296.4	323.5	303.3
Shareholders Equity	334.0	376.2	413.7	452.1	492.6
Minority Interest	2.3	2.9	3.1	4.3	5.5
Total shareholder equity	336.3	379.0	416.8	456.4	498.1
Total liabilities and equity	563.8	688.1	713.2	779.9	801.4

CASH FLOW (SGD m)

Pretax profit	51.9	70.5	64.2	67.5	71.1
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)	(25.8)	6.7	(14.5)
Cash taxes paid	(5.9)	(16.2)	(10.4)	(11.5)	(12.1)
Other operating cash flow	6.2	0.0	0.0	0.0	0.0
Cash flow from operations	74.4	42.6	52.3	88.7	72.3
Capex	(28.9)	(33.9)	(16.1)	(51.0)	(52.8)
Free cash flow	45.5	8.7	36.2	37.7	19.5
Dividends paid	(12.8)	(17.6)	(16.1)	(16.5)	(17.4)
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	8.5	2.9	2.9
EBITDA growth	(0.5)	18.5	(5.3)	5.7	5.7
EBIT growth	(0.7)	22.1	(8.7)	5.0	5.2
Pretax growth	(3.8)	36.0	(8.9)	5.1	5.3
Reported net profit growth	1.1	37.1	(8.7)	2.3	5.5
Core net profit growth	5.4	19.7	(8.7)	2.3	5.5
Profitability ratios (%)					
EBITDA margin	12.9	12.4	10.8	11.1	11.4
EBIT margin	9.5	9.4	7.9	8.0	8.2
Pretax profit margin	8.4	9.2	7.7	7.9	8.1
Payout ratio	34.2	30.0	30.0	30.0	30.0
DuPont analysis					
Net profit margin (%)	6.9	7.7	6.4	6.4	6.6
Revenue/Assets (x)	1.1	1.1	1.2	1.1	1.1
Assets/Equity (x)	1.7	1.8	1.7	1.7	1.6
ROAE (%)	13.6	16.5	13.6	12.7	12.2
ROAA (%)	9.2	9.4	7.7	7.3	7.3
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	2.1	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	46.8	49.1	51.7
Debt/EBITDA (x)	0.8	1.0	1.1	1.0	1.0
Capex/revenue (%)	4.7	4.4	1.9	6.0	6.0
Net debt/ (net cash)	(107.1)	(95.4)	(115.5)	(136.8)	(138.9)

Source: Company; Maybank IBG Research

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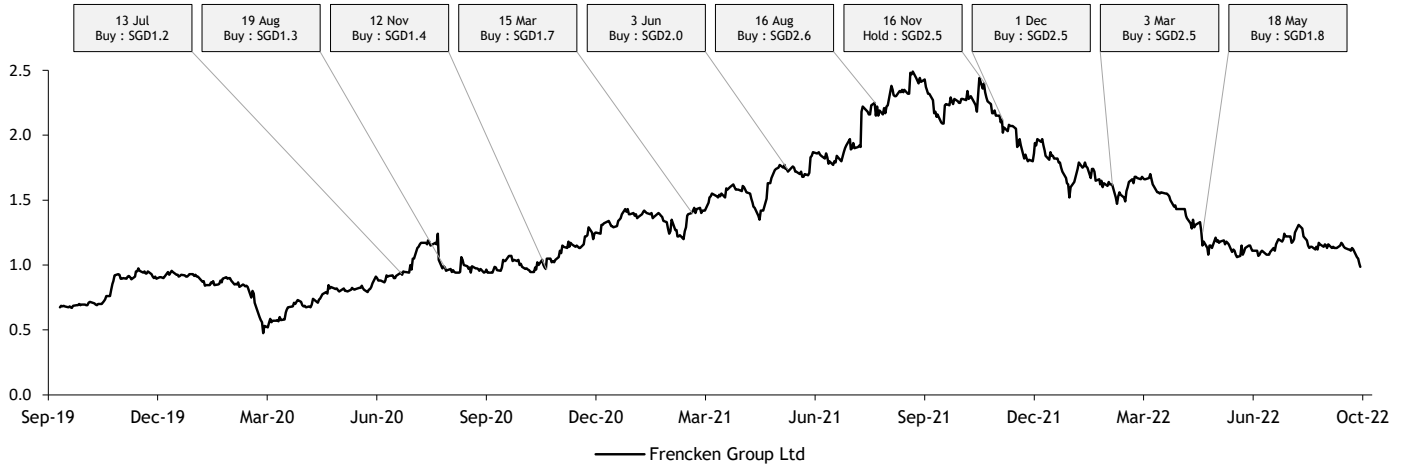
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Historical recommendations and target price: Frencken Group Ltd (FRKN SP)



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