AmInvestment Bank

Sector report

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EMS

Cautious on recovery amid second wave fears

UNDERWEIGHT

(Maintained)

Rationale for report: Sector update

Investment Highlights

- **We have an UNDERWEIGHT recommendation on the Electronics Manufacturing Services (EMS) sector for 2H20** as we believe that the demand for its customers' end products — household consumer products such as floor care and personal care products, coffee machines, and pool cleaners — might see a slower-than-expected recovery due to fears of a second wave of Covid-19 infections globally impacting consumer sentiments. This is despite the sector's positive longer term prospects arising from: (i) ties to a key UK customer's growth prospects supported by its product launches; and (ii) a potential to diversify the manufacturers' customer base with opportunities to be secured following the US-China trade war diversion and changes in global supply chain following Covid-19 shocks.

- Stocks under our coverage are **V.S. Industry (UNDERWEIGHT, FV RM0.80),** and **ATA IMS (UNDERWEIGHT, FV RM1.05)** which we have downgraded from HOLD calls previously as their valuations were deemed unattractive after the rise in share prices. We have lowered our target PE for both companies to 10x (from 14x previously) premised on expectations of a slower-than-expected recovery in demand as we also see that the majority of their key customers' sales come from the Americas and the Europe, Middle East & Africa (EMEA) regions which have seen more severe outbreaks of Covid-19 while Asia-Pacific countries such as India have also yet to contain the spread of the virus effectively, with the risk of resurgence in cases and new infections seen globally.

- **Covid-19 impact on factory operations:** In order to contain the spread of Covid-19 in Malaysia, the movement control order (MCO) effective 18 March 2020 had caused EMS players to experience production halts until mid-April 2020 where both companies were allowed to resume productions at limited capacity of 25% of its total workforce and required to comply with certain standard operating procedures (SOPs) set by the government. With the gradual easing of MCO restrictions, workforce capacity was allowed to increase to 50% and VSI has said that its Malaysian operations are back to full capacity. As for VSI's overseas operations, its China operations have resumed operations since mid-February 2020 albeit still facing challenges of underutilization of facilities which will be offset by its lower opex on cost optimization efforts. Overall weaker revenues, coupled with still having to incur fixed expenses, caused a dent in 1Q20 earnings, dragging VSI into the red and recording a core loss of RM15mil in 3QFY20.

- **Negotiations with prospects hit a pause:** Due to travel restrictions imposed, discussions with prospective customers following the US-China trade war diversion were disrupted as there were limitations on conducting audits and site visits. On the plus side, VSI said that two to three of its prospects are at the later stages of discussion, and communications have continued online. On the plus side, the group has recently secured a new automotive customer which is expected to contribute less than RM50mil revenue in FY21. Although the initial contribution is only ~2% of revenue, VSI is positive on the long-term potential for this customer. We anticipate negotiations would only start to show progress when travel restrictions have been significantly eased globally.

- **Production has since resumed:** Production for newer models of one of VSI's key US customer was pushed back by around 1–2 months due to the MCO but has since resumed in May 2020. The group has two more models slated to begin production by end-2020 and another in February 2021, having secured a total of five models from said customer. We have factored in the impact of the production delays and anticipated order flow slowdown in our forecasts.

- **Anticipating order flow slowdown amid weak consumer sentiments:** Both EMS players advised caution on expectations of weaker global sentiments to translate to subdued demand for its customers' end products overall. In an article on 5 June 2020, McKinsey & Co said that net consumer optimism has decreased despite countries reopening, with overall net spending intent being lower due to Covid-19's impact on consumer incomes which has limited spending to essentials and non-discretionary categories with the exception of South Korea and China. Meanwhile, VSI has also said that order visibility for its key UK customer has halved to 6 months.

- **Potential changes in sector rating:** We may upgrade the sector to NEUTRAL/OVERWEIGHT if: (i) consumer sentiments improve significantly translating to higher demand for its customers' end products; (ii) the companies secure major orders and/or key customers which boosts box-build orders; and (iii) improvements in the performance of overseas operations (such as VSI's) due to comeback in sales orders on top of better cost-saving initiatives.

- **We have no top picks for this sector.**

EXHIBIT 1: PEER COMPARISON

Company	Recomm	Price	FV	Upside	Mkt Cap	P/E (x)		EPS (sen)		EPS Growth (%)		P/B		ROE (%)		DY (%)		EV/EBITDA	
		RM	RM	%	(RM mil)	CY20	CY21	CY20	CY21	CY20	CY21	CY20	CY21	CY20	CY21	CY20	CY21	CY20	CY21
VS Industry Bhd	UNDERWEIGHT	1.28	0.80	(37.5)	2,336.4	21.2	16.0	6.0	8.0	(25.8)	32.7	1.3	1.3	6.7	8.5	2.0	2.0	7.6	6.1
ATA IMS Bhd	UNDERWEIGHT	1.26	1.05	(16.7)	1,503.6	15.0	12.0	8.4	10.5	14.1	24.7	2.1	1.9	14.6	16.5	2.3	2.9	8.9	7.2
SKP Resources Bhd	n.a.	1.40	n.a.	n.a	1,712.3	15.2	12.2	9.0	11.3	26.8	25.3	2.6	2.4	17.6	20.5	2.9	4.4	8.9	7.3
PIE Industrial Bhd	n.a.	1.57	n.a.	n.a	583.7	22.7	14.5	6.7	10.5	(15.2)	(29.5)	56.7	1.3	1.2	7.2	8.1	2.6	3.6	13.8
Uchi Technologies Bhd	n.a.	2.61	n.a.	n.a	1,159.0	14.3	15.0	10.4	(15.9)	4.9	6.7	6.2	39.1	44.5	4.8	5.2	15.2	14.0	14.0
Simple avg						***17.7***	***13.9***	***8.1***	***4.9***	***0.9***	***12.0***	***13.8***	***9.2***						
Market cap weighted avg						***17.5***	***14.0***	***8.0***	***5.7***	***0.5***	***20.2***	***7.0***	***7.7***						

Source: Bloomberg, AmInvestment Bank Bhd. Prices as at 23 July 2020.

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