Securities

AFFIN HWANG CAPITAL

Out**think.** Out**perform.**

1Q16 technology sector earnings round-up

1Q16 earnings disappointed, with several big misses from key players. We have cut our 2016E sector earnings to -5% from +8% previously. Although earnings are expected to rebound in 2Q16, we remain cautious given prevailing economic uncertainty. Maintain Neutral sector weighting, with Inari, Uchi and Scicom for exposure.

Disappointing 1Q16…

Half of the companies under our coverage missed expectations this quarter. The disappointment was predominantly underpinned by an inventory imbalance, weak demand for a major smartphone brand and efforts by that same brand to reduce inventory. The latter reason negatively affected mostly Inari and Globe, which form part of the supply chain. Weak revenue guidance or a further 15-19% qoq contraction for that major brand in the upcoming quarter could remain near-term dampeners for the sector.

…but earnings should rebound in 2Q16

Save for the depreciation of the RM during the quarter, we nevertheless expect earnings to rebound in 2Q16, albeit at a weaker pace. Most of the OSATs have guided for sequential revenue growth (+5 to +10% qoq). In Inari's case, we expect higher revenue growth of +20% qoq, possibly due to the base effect (revenue contracted the sharpest, or by -26%, in the previous quarter).

Sector earnings cut to -5% yoy for 2016E

On the whole, we cut our 2016E sector earnings growth to -5% yoy from +8% yoy in the previous quarter. At the same time, we think that some of the negatives may have been priced in already. Ytd, the technology index is down 17% and has underperformed the broader FBMKLCI's 4% decline. However, we think the sector lacks a strong re-rating catalyst, especially amidst global macroeconomic uncertainties.

Maintain Neutral; Inari, Uchi and Scicom are our top picks

We maintain our Neutral view on the sector, and think that it is still best to be selective in terms of stock selection. Inari is one of our top picks, as we are confident on its long-term growth prospects for both its RF operations as well as on the fibre optics front. We also like niche player Uchi for its attractive dividend yields of 6%. In the non-semiconductor space, we like Scicom not only for its stable earnings from its BPO segment but also the rising contribution from its higher margin e-government service, EMGS.

Sector Update

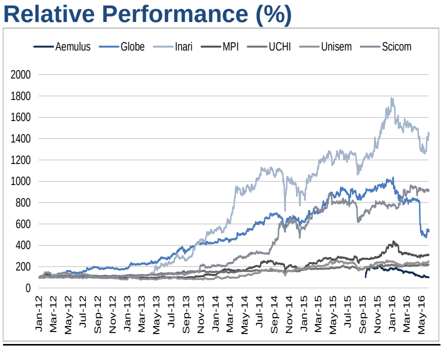
Technology

Neutral (maintain)

Absolute Performance (%)

	1M	3M	12M
Aemulus	-5.2%	-35.3%	na
Globe	+1.5%	-37.2%	-40.4%
Inari	+11.7%	-7.9%	+8.1%
MPI	-0.3%	-7.8%	+5.7%
Uchi	+0.6%	+5.5%	+8.1%
Unisem	+9.0%	+7.6%	-2.4%
Scicom	-1.3%	+2.2%	+10.5%

Relative Performance (%)



Source: Affin Hwang, Bloomberg

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Peer Comparison

	Rating	Sh Pr (RM)	TP (RM)	Mkt Cap (RMm)	Year end	Core PE (x) CY16E	Core PE (x) CY17E	EPS growth (%) CY16E	EPS growth (%) CY17E	EV/EBITDA (x)	P/B (x)	ROE (%) CY16E	ROE (%) CY17E	Div. Yield (%) CY16E	Div. Yield (%) CY17E
Aemulus	SELL	0.275	0.20	121	Sep	20.3	21.6	-28.2	-6.2	13.4	1.8	7.1	7.2	0.0	0.0
Globetronics	HOLD	3.47	3.87	977	Dec	18.8	13.4	-13.7	39.6	10.6	3.2	36.2	37.4	4.8	6.7
Inari	BUY	3.05	3.54	2,901	Jun	17.4	14.5	16.9	20.4	12.7	4.6	26.4	26.5	2.1	2.5
MPI	HOLD	7.38	7.91	1,549	Jun	10.2	13.1	4.4	-22.2	3.7	1.7	15.2	12.2	3.1	2.7
Scicom	BUY	2.32	2.58	825	Jun	18.0	18.0	19.9	-0.3	15.1	8.9	45.0	39.5	3.6	3.9
Uchi	BUY	1.74	1.90	653	Dec	12.8	13.3	-6.9	-3.8	8.6	2.8	21.7	20.1	6.3	6.3
Unisem	SELL	2.41	1.76	1,733	Dec	16.3	16.1	-33.9	1.3	5.9	1.2	7.8	7.6	3.7	3.7
Average						**15.1**	**14.6**	**-5.0**	**3.4**	**10.0**	**3.5**	**22.8**	**21.5**	**3.4**	**3.7**

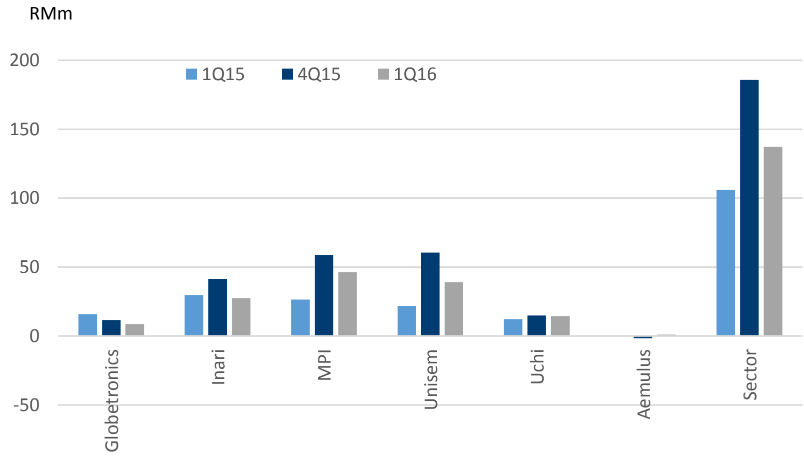
Source: Affin Hwang estimates, Bloomberg; stock prices as of 1 June 2016

1Q16 earnings round-up

1Q16 sector earnings decline 29% qoq

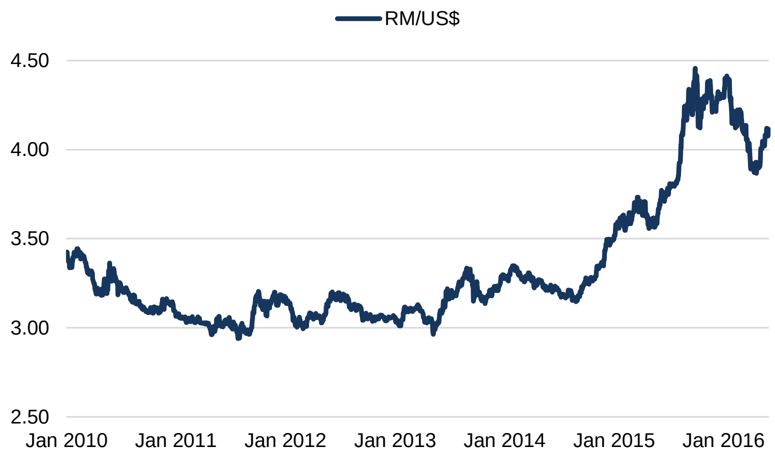
1Q16 sector core earnings contracted a sharp 26% against 4Q15 (Fig 1). Earnings were broadly lower across the semiconductor OSATs under our coverage, except for equipment manufacturer, Aemulus. This was nevertheless merely due to the company returning to the black for the quarter. Apart from seasonality, the appreciation of the RM was a drag on profitability to the exporters. Despite this, 1Q16 sector earnings were higher by 24% compared to a year ago. This, we reckon is only due to the RM depreciation (Fig 2).

Fig 1: Sector earnings contract 29% qoq



Source: Companies, AffinHwang

Fig 2: RM has again started to weaken vis-à-vis the US$

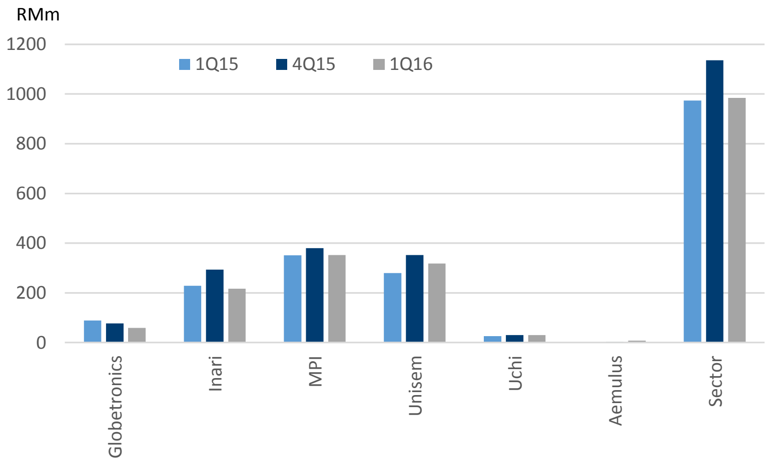


Source: Bloomberg

Weak revenue more pronounced without currency gains

Sector revenue fell 13% qoq amidst a slowdown caused by seasonality and weaker demand in the smartphone segment. Companies under our coverage that had higher exposure to a major smartphone brand and to the overall communication segment – Inari, Globe and Unisem, were more heavily impacted. We estimate that revenue contribution from the communication segment for the three were approximately 50%, 45% and 31% respectively. Revenue contraction for the quarter was further compounded by the 2% appreciation in the RM, which in the recent past quarters provided a lift to revenue and hence earnings.

Fig 3: Sector revenue down 13% qoq

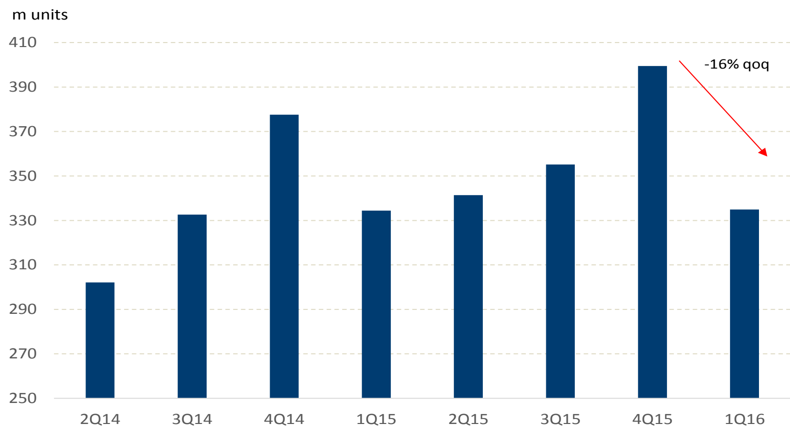


Source: Companies, AffinHwang

Companies with exposure to Apple brand more affected

More importantly, companies that had greater exposure to the Apple brand were more negatively impacted by its disappointing sales and targeted channel inventory reduction. For the quarter, Apple's smartphone shipments contracted sharply by 32% qoq compared to the broader industry's 16% qoq decline (Fig 4). For companies under our coverage, Inari and Globe reported the sharpest revenue decline of 26% and 24% respectively.

Fig 4: Apple smartphone sales down 32% qoq vs industry's -16% qoq



Source: IDC

Apple guides for up to 19% qoq revenue decline in upcoming quarter

Apple has also guided for a 15%-19% qoq decline in its fiscal 3QFY16 revenue, which could be a dampener for local OSATs in the coming quarter. On a more positive note, the RM has weakened slightly qoq while we suspect that manufacturing volume may progressively see a ramp up as inventory is built for the future launch despite the weaker revenue in the near term.

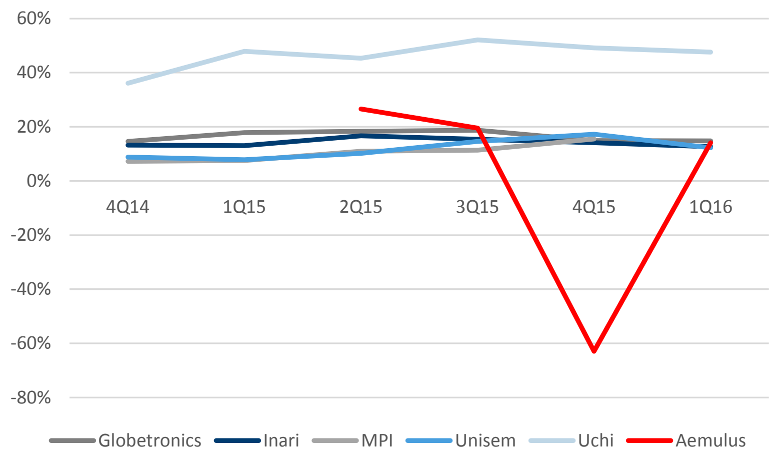
3 companies miss expectations, 1 in line and 2 above

Although sector earnings were broadly negative this quarter, it appeared as if this was well flagged. Results were broadly in-line with our expectations with the exception of Globe and Aemulus although we did cut our EPS estimates for Inari prior to its results. Summing it up, 3 out of our 6 semiconductor companies fell below expectations. Unisem's 1Q16 net profit was inline with expectations while MPI and Uchi's results both surprised to the upside. MPI's better-than-expected results were attributed to firm cost control while Uchi's was driven by a weak RM.

Margins hold up on cost efficiency

Because of the weaker revenue, profitability of the companies under our coverage was adversely affected in 1Q16. While margins were slightly softer qoq, we do not sense anything extraordinary. In fact, margins held up better-than-expected despite the lower operating leverage. We attribute this to a general focus on cost efficiency.

Fig 5: Margins have been relatively stable



Source: Companies, AffinHwang

Earnings and rating revisions

Sector earnings growth cut to -5% yoy from +8%

Post the 1Q16 results season, we downgrade our 2016E sector earnings growth to -5%, from +8% yoy growth in our last sector report in March. The weaker earnings were dragged down predominantly by earnings cut for both Inari and Globe. We now expect Globe to register weaker earnings on a yoy basis, due to softer loadings for its proximity sensors and the uncertainty over the extent of adoption of its imaging sensors. Inari's RF division has likewise been affected by weaker demand although we still project an EPS growth of +15% for FY2016. Management has guided for sequential revenue improvement of +20% and we believe that earnings may have seen its worse in 3QFY16.

Fig 6: 2Q16 revenue guidance

	2Q16 revenue guidance
Aemulus	n.a
Globetronics	Flattish
Inari	Up to +20%
MPI	+5%
Unisem	+5% to +10%
Uchi	n.a
Scicom	n.a

Source: AffinHwang, Companies

MPI upgraded to Hold, Globe downgraded from Buy to Hold

We recently upgraded MPI to a Hold from Sell after its share price pullback and on valuations. Meanwhile, we cut Globe to a Hold after its disappointing set of earnings and concerns over earnings risk given the uncertainty over new product launches from its key customer.

Fig 7: Key rating/TP changes

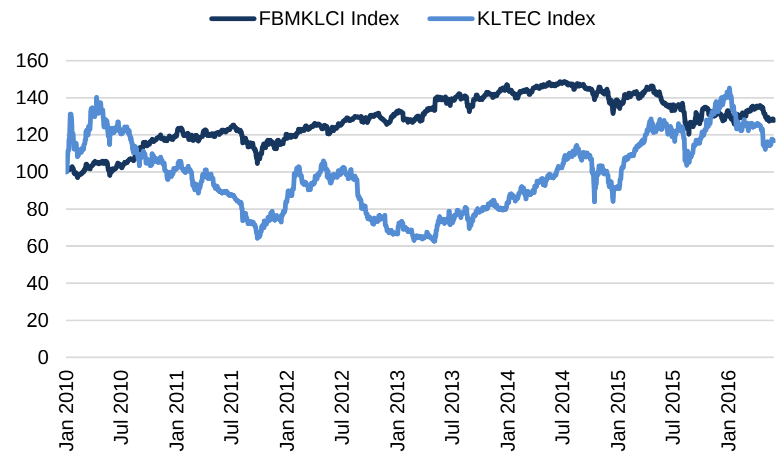
	Rating		TP (RM)	
	Before	After	Before	After
Aemulus	Sell	Sell	0.34	0.20
Globetronics	Buy	Hold	7.06	3.87
Inari	Buy	Buy	3.54	3.54
MPI	Sell	Hold	7.74	7.91
Unisem	Sell	Sell	1.76	1.76
Uchi	Buy	Buy	1.90	1.90
Scicom	Buy	Buy	2.58	2.58

Source: AffinHwang estimates

Sector rating and stock recommendations

Maintain Neutral; Inari, Uchi and Scicom are our top picks

The Technology Index which has declined 17% ytd has also underperformed the broader FBMKLCI's decline of 4%. This can be attributed to a number of reasons including slowing smartphone sales and a cyclical inventory overhang. In our view, the key headwind that contributed to the weak sector price performance was however due to the steady appreciation of the RM (although has subsequently reversed from April 2016).



Source: Bloomberg

All in all, with the above factors still mostly in play, we are keeping our Neutral view on the sector and think that it is still best to be selective in terms of stock selection. Inari is our top pick as we are confident on its growth prospects for both its RF operations as well as on the fibre optics front. We believe LTE adoption will continue to raise RF content per device driving growth despite an overall slowdown in smartphone sales while a take-off in IOT will accelerate the demand for its fibre optic products. We also like Uchi for its attractive dividend yields of 6%. Although sales have been unexciting, managements remain committed to returning excess cash to shareholders. In the non-semiconductor space, we like Scicom not only for its stable earnings from its BPO segment but also the rising contribution from its higher margin e-government service, EMGS.

Risks

Key upside risks include a strong upturn in demand for semiconductors. This could possibly be underpinned by improving macro fundamentals of major economies leading to improved capex spending and consumer spending. Further strengthening of the US$ vis-à-vis the RM could also potentially lead to further revenue growth and margin expansion. Downside risk includes a prolonged semiconductor downturn leading to further inventory imbalance and higher-than-expected ASP erosion. Weaker-than-expected demand for smartphones due to lack of compelling new features and expensive price points pose a key risk.

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +10% over a 12-month period
HOLD	Total return is expected to be between -5% and +10% over a 12-month period
SELL	Total return is expected to be below -5% over a 12-month period
NOT RATED	Affin Hwang Investment Bank Berhad does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation

The total expected return is defined as the percentage upside/downside to our target price plus the net dividend yield over the next 12 months.

OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

This report is printed and published by:
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