Sarine Technologies

Industrials

16 August 2018

Cost reductions driving profitability

Sarine's prudent cost management in Q218 translated into a 12.4% y-o-y increase in EBIT to US$4.7m, despite the lack of top-line growth. The company continues to focus on increasing the recurring revenue streams from retail-oriented services led by Sarine Profile and the 4Cs grading reports, with its second technology lab that recently opened in Mumbai. Despite the progress in already initiated projects with downstream customers being slower than expected, management remains confident that these services will become an important contributor to group sales.

Q218 earnings up on costs and tax rate reduction

Sarine reported a Q218 EPS of 1.18 US$ cents, up by 27.9% y-o-y on the back of lower operating expenses and more normalised tax rate (13.2% vs 23.6% in Q217). R&D costs were lower by 19.7% y-o-y at US$2.5m following last year's peak in spending, while sales and marketing costs declined 4.9% y-o-y to US$3.6m, partially due to team restructuring. A temporary break in the IP litigation processes resulted in only a modest increase in G&A expenses at 2.3% y-o-y. Group revenues were down 1.1% y-o-y to US$18.0m.

Recurring revenues flat, Galaxy sale slightly lower

Sarine's top line in Q218 was influenced by lower rough diamond sales in volume terms by major players such as De Beers, as well as slightly lower revenues from capital equipment (despite selling 20 Galaxy family units vs 16 systems in Q217). Contribution from retail-related services remained at around 2%, although it must be noted that sales in this segment grew by 33% y-o-y in Q218 amid increasing adoption of Sarine Profile. However, management highlighted that delays in co-operation ramp-up on the customer side triggered a downward revision of its expectations of the number of scanned stones in 2018.

Valuation: Consensus unchanged, share price down

Sarine's shares currently trade at FY18e and FY19e P/E ratios of 11.9x and 9.2x, representing a 47% and 55% discount to selected peers operating in the laboratory and site-based materials analysis and testing business, respectively. This is based on an average EPS forecast from two brokers at 5 US$ cents in FY18 and 6.5 US$ cents in FY19. Sarine's shares currently offer an attractive dividend yield of c 6%.

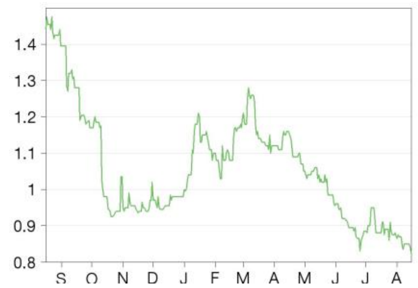
Consensus estimates

Year end	Revenue (US$m)	PBT (US$m)	EPS (c)	DPS (c)	P/E (x)	Yield (%)
12/16	72.5	22.0	5.14	4.50	11.6	7.6
12/17	58.6	9.4	1.64	3.50	36.3	5.9
12/18e	74.8	21.7	5.00	3.90	11.9	6.5
12/19e	85.0	28.4	6.50	4.80	9.2	8.1

Source: Sarine Technologies accounts, Bloomberg consensus as at 14 August 2018.

Price	**S$0.80**
Market cap	**S$288m**
	US$/S$1.37

Share price graph



Share details

Code	SARINE.SP
Listing	SGX
Shares in issue	350.7m

Business description

Sarine is the leading provider of equipment and services for the diamond manufacturing industry. These help to automate planning and maximise yield. It has also developed products that allow it to enter the much larger and more profitable wholesale and retail segments of the industry.

Bull

- Leading market position, strong customer base and proprietary technology.
- Expanding into new and larger addressable downstream market.
- Strong balance sheet (net cash position of US$32.1m).

Bear

- Earnings heavily reliant on low-profitability customers.
- Copyright infringement.
- Low liquidity.

Analyst

Milosz Papst +44 (0)20 3077 5700

industrials@edisongroup.com

Edison profile page

Sarine Technologies coverage is provided through the SGX research scheme.

Q2 financials: Sales flat, but opex and tax rate down

Sarine reported a 12.4% y-o-y EBIT increase in Q218, assisted by the reduced R&D costs (down 19.7% y-o-y to US$2.5m) following the completion of new product development (AI-based 4Cs grading and Sarine Journey), as well as lower sales and marketing expenses. The latter resulted from Sarine's sales and marketing team restructuring, as well as lower expenses related to marketing and trade shows. Sarine's management plans to increase its marketing expenses from Q418, in particular for team expansions in Asia Pacific (mainly China) and subsequently also in the US. G&A expenses were up only modestly (+2.3% y-o-y) due to lower litigation costs during the summer break in May. Gross margin reached 67.8% compared with 68.4% in Q217, which is partially the result of preliminary set-up expenses related to the newly opened Sarine Technology Laboratories. A normalisation of the tax rate (13.2% in Q218 vs 23.6% in Q217) has also contributed to the 27.9% y-o-y EPS increase to 1.18 US$ cents.

Sarine's revenues were broadly stable y-o-y (-1.1% vs Q217), with recurring revenues being flat y-o-y in Q218 (representing c 40% of group sales) despite the installed base of Galaxy systems increasing from 332 units at end-June 2017 to 377 at end June-2018. This is a result of the lower number of rough diamonds entering the pipeline in H118 compared to the prior year (see below) and still relatively limited contribution from Sarine Profile. Revenues from equipment sale were marginally below Q217 due to growing contribution of systems for scanning smaller stones. Nevertheless, sales improved sequentially by 7.8%, assisted by a higher number of Galaxy family systems delivered to customers (20 systems in Q218, compared with 12 systems in Q118). This includes eight models of the recently introduced Meteorite system for scanning very small rough diamonds, which is characterised by a cost-effectiveness advantage vs products offered by Sarine's illicit competition. Importantly, the sale of systems for scanning smaller stones contributes to a lesser extent to future recurring revenues, as more than half of these transactions generate only upfront income with no subsequent regular subscription fees. India remained the company's key end-market, contributing 67% to group sales in Q218. It is worth noting that sales to Africa more than doubled y-o-y to US$2.6m, driven by the delivery of three Galaxy systems and one Galaxy Ultra model. However, management perceives the business opportunity in this region as limited for now.

Retail-related revenues (primarily from Sarine Profile) stood at 2% of group revenue, with a nearly 25% y-o-y improvement in H118 (and a 33% increase y-o-y in Q218), although they are still below the company target of 5%. The product is already in use at over 1,000 retail locations across APAC and the US. The company is in the final stages of opening a new service centre, which will serve the Japanese market and facilitate access to Sarine Profile reports by Japanese retailers. Nevertheless, delays in ramp-up by clients have led to revised management expectations of the number of stones scanned, which is no longer expected to double in 2018.

Sarine's cash position improved from US$29.1m at end-2017 to US$32.1m as at end-June 2018, although it was down from the US$35.5m reported at end-March 2018. The company generated an operating cash flow in Q218 at US$3.0m supported by higher profitability, even though it was below the Q217 level of US$5.5m due to working capital movements. In particular, accounts receivable increased from US$17.6m in Q217 to US$20.2 in Q218, as customers requested longer payment periods amid fears related to the weakening Indian rupee. However, Sarine's management considers this a temporary situation without any persisting impact on its business.

Capital expenditure remained below the previous year (US$0.8m vs US$1.0m) and were mainly related to the opening of new Sarine Technology Labs in Ramat Gan and Mumbai. In conjunction with the dividend payment of US$5.3m and cash outflow for share buyback (US$0.4m), this translated into a net cash decline of ~ US$3.0m during the quarter. Management declared an interim dividend at 2 US$ cents per share for H118.

Exhibit 1: Results highlights

US$000s	Q218	Q217	Y-o-y (%)
Revenues	**17,959**	**18,151**	**-1.1%**
Cost of sales	(5,775)	(5,730)	0.8%
Gross profit	**12,184**	**12,421**	**-1.9%**
Gross margin	*67.8%*	*68.4%*	*-59bp*
Research and development costs	(2,454)	(3,057)	-19.7%
Sales and marketing expenses	(3,556)	(3,741)	-4.9%
General and administrative expenses	(1,500)	(1,466)	2.3%
Operating profit	**4,674**	**4,157**	**12.4%**
EBIT margin	*26.0%*	*22.9%*	*312bp*
Net finance income (expense)	87	72	20.8%
Income taxes	(629)	(999)	-37.0%
Post-tax profit	**4,132**	**3,230**	**27.9%**
Net margin	*23.0%*	*17.8%*	*521bp*
Weighted diluted average number of shares (000s)	351,120	351,143	0.0%
Diluted EPS (c)	**1.18**	**0.92**	**27.9%**

Source: Sarine Technologies accounts

Sarine remains on course with its initiatives to prevent IP infringement, which includes migration to the Advisor 7.0 planning software (incentivised by the fact that this is the only version supporting Sarine Profile), legal actions, as well as increasing the pressure on infringing parties through the involvement of importers and dealers, such as Tiffany or Signet.

Midstream market: Stable with some downside risks

Diamond jewellery demand remains strong following a 7% y-o-y sales growth globally in Q118 (vs a 2010–2017 CAGR of 4%) according to Alrosa, fuelled by positive consumer sentiment and the macroeconomic environment, especially in the US, Europe and China. Simultaneously, the market experienced a reduction in rough diamond supply. De Beers' rough diamond sales during the Q218 sights were up only 0.6% y-o-y and for all six sights year-to-date were down 2.4% y-o-y. Given that rough diamond prices are c 2–3% higher y-o-y (according to Sarine), this suggests a mid-single digit decline in rough diamond sales in volume terms. Similarly, Alrosa's rough diamond sales in Q218 declined c 6% y-o-y. As a result, although polished diamond prices generally remain stable or even increase slightly (polishedprices.com's index is up c 4% y-o-y), Sarine currently sees some initial margin pressure materialising in the midstream segment. However, it must also be noted that midstream inventories remain at reasonable levels after the recent normalisation, which reduces the likelihood of a significant oversupply in Q318. Moreover, De Beers' production of rough diamonds in H118 increased by 8% y-o-y to 17.5m carats, reflecting the company's confidence in prospective market demand. Similarly, Rio Tinto reported a production increase at its Argyle project of 13% y-o-y in H118 (with the smaller Diavik project reporting a minor 2% decline).

In line with the potential risk we've highlighted in our previous update report, the recent fraud scandal involving Gitanjali Gems has negatively affected the willingness of Indian banks to provide funding to the local gems and jewellery industry (traders in particular). According to the Gems and Jewellery Export Promotion Council (GJEPC), bank lending declined c 10% y-o-y in Q118. Moreover, banks have increased their collateral requirements and also demand more extensive documentation from potential borrowers. The industry recently faced another scandal, where the inflated value of imported stones was used to transfer black money out of the country. On the positive side, the Indian jewellery industry benefits from a reduced goods and services tax rate (to 0.25% from 3.0%) introduced at the beginning of the year. As highlighted above, Indian manufacturers represented 67% of Sarine's revenue in H118.

Valuation

Sarine trades on a trailing 12-month P/E of 25.2x (when adjusted for the US$1.0m write-down of deferred and other tax assets recognised in Q417). Based on Bloomberg consensus figures for 2018 and 2019, the shares are trading on P/Es of 11.9x and 9.2x, respectively, with expected y-o-y EPS growth of c 160% (on an adjusted basis) and 30%, respectively. We note that the market consensus includes only two broker estimates.

Sarine's valuation and upside is mainly dependent on its expansion in the downstream segment, which should further support earnings growth and improvements in profitability and returns. Some premium can be expected, given Sarine's industry position and leadership in technology. We believe that ROE has scope to improve at least partially towards 2014 levels (34% vs current LTM ROE at c 10%) in the longer term, as R&D expenditure peaked, while revenues from investments should become meaningful from 2018 onwards.

Given the lack of direct listed peers, we have combined a set of companies active in the laboratory and site-based materials analysis and testing business. Although we acknowledge that these companies operate in different markets from Sarine, we have identified some similarities to Sarine's activities (see detailed descriptions below). Sarine is trading at a discount to this peer group on both P/E and EV/EBITDA ratios of c 40–70%.

In the peer comparison table (Exhibit 2), we also show one Indian company primarily engaged in midstream manufacturing. Moreover, given Sarine's focus on expanding into the downstream market, it is instructive to look at players in this area with strong brands and balance sheets. However, it should be noted that these companies cannot be treated as close peers, given that Sarine's current exposure to the retail business is just c 2% of group sales. Chow Tai Fook (the largest jewellery retailer in China and Hong Kong) and Tiffany & Co both trade at significant premiums to Sarine on both forward P/E and EV/EBITDA ratios. The premiums are likely a reflection of their very strong brands and market positions in jewellery retailing.

Exhibit 2: Peer comparison

	Market cap (m)	PE (x)			EV/EBITDA (x)		Dividend yield (%)
		Past 12 months	2018e	2019e	2018e	2019e	2018e
Bruker Corporation	US$5,349	30.5	24.9	22.5	14.7	13.6	0.5%
Bureau Veritas	€9,834.9	29.5	22.8	20.9	14.0	13.1	2.6%
Spectris	US$2,713	9.3	14.8	13.5	10.9	10.0	2.7%
Intertek Group	US$8,455	29.2	26.7	24.6	15.5	14.4	1.8%
Peer group average		24.6	22.3	20.4	13.8	12.8	1.9%
Sarine Technologies	S$288	25.2	11.9	9.2	4.7	3.7	6.5%
Premium/(discount)		**2%**	**(47%)**	**(55%)**	**(66%)**	**(71%)**	**(71%)**
Asian Star	INR14,773	13.8	12.0	10.1	10.2	8.8	N/A
Chow Tai Fook	HK$66,200	16.2	13.6	11.9	9.0	8.0	5.6%
Tiffany & Co	US$16,480	28.9	27.7	24.5	15.2	14.0	1.6%

Source: Company accounts, Bloomberg. Note: Prices as at 14 August 2018. *Adjusted for the US$1.0m write-down of deferred and other tax assets.

Main peers

Bruker Corporation is a manufacturer of advanced analytical instruments used within the academic and government, pharma/biotech, clinical diagnostic and industrial markets. Part of Bruker's business covers analytical solutions enabling the development, production and refinement of metals at highest quality standards. Bruker also offers solutions for gold analysis, gold assay and gold carat determination.

Bureau Veritas is a global leader in testing, inspection and certification; its commodity division provides a wide range of inspection and laboratory testing services. In the exploration and mining segment, the company has the global infrastructure and expertise to service exploration, mine assaying and metallurgical testing projects. Industry applications represent around one-quarter of group revenue.

Spectris is a supplier of specialised measuring instruments and controls for technically demanding industrial applications. Around 60% of group sales are derived from materials analysis, as well as test and measurement services (both laboratory and offline). Key end-markets for materials analysis include metals/minerals/mining, pharma/fine chemicals, academic research and semiconductors.

Intertek is a leading total quality assurance provider, offering, among others, services in the area of materials testing of metals to assess the suitability, integrity and safety of products, components and assets. Intertek's technicians provide laboratory and site-based materials testing of metals. The company uses state-of-the-art 3D digital measurement software, which comprehensively delineates physical objects and is accurate to one ten-thousandth of an inch.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia