Sarine Technologies

Industrials

18 May 2018

Growing importance of recurring revenue

Following a considerable oversupply of polished diamonds in H217, conditions in the midstream market have returned to normal post the holiday selling season, as expected. Sarine was able to post a slight increase in sales in Q118 vs the previous year on the back of higher recurring income from its inclusion mapping systems. Equipment sales were largely focused on systems for smaller stones, including the recently launched Meteorite system. Going forward, management expects increased adoption of its comprehensive offering including Sarine Profile, the light performance grading tools, Sarine Diamond Journey and the AI-based 4C grading reports to further drive recurring revenue.

Q118 results reflect the move towards market balance

Sarine reported an EPS of 0.88 cents (US$), implying 26.5% y-o-y growth. This was a function of a lower tax rate, a decline in R&D expenses and a 2.4% y-o-y increase in revenue. G&A expenses were up 22.2% y-o-y due to continued IP litigation efforts. Top-line growth was largely driven by recurring revenues (which made up 45% of group sales in Q118 vs 42% last year) on the back of recovering midstream activity. Solid operating cash flow (US$6.6m vs US$4.6m in Q117) and reduced property, plant and equipment spending translated into a net cash position of US$35.5m as at end-March 2018.

Active pursuit of growth in the downstream segment

Even though Sarine Profile's contribution to group sales remained at a modest 2% in Q118, there are already new and expanding programmes from new and existing customers in Asia Pacific, with more in the process. A Japanese retailer (K-Uno) has decided to adopt Sarine's 4C grading reports issued by its recently opened lab in Israel. Moreover, the company plans to open another lab in India in May to address the needs of higher-volume retail customers in the Asia Pacific region. Sarine also continues to implement measures to limit IP infringement, including legal actions as well as stimulating the migration to its newest Advisor 7.0 software.

Valuation

Sarine's shares currently trade at FY18e and FY19e P/E ratios of 15.4x and 11.8x, representing a 30% and 41% 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.

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	15.0	5.9
12/17	58.6	9.4	1.64	3.50	46.9	4.6
12/18e	74.8	21.7	5.00	3.90	15.4	5.1
12/19e	85.0	28.4	6.50	4.80	11.8	6.2

Source: Sarine Technologies accounts, Bloomberg consensus as at 15 May 2018

Price	**S$1.03**
Market cap	**S$362m**
	US$/S$1.34

Share price graph

Share details

Code	SARINE.SP
Listing	SGX
Shares in issue	351.3m

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$35.5m).

Bear

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

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Sarine Technologies coverage is provided through the SGX research scheme.

Q1 financials: Midstream activity assisting results

Top line driven by recurring revenue

Sarine's revenues improved by 2.4% y-o-y to US$16.7m in Q118, assisted primarily by growth in recurring revenue from inclusion mapping systems, on the back of a rebound in midstream activity after the weak H217, despite the c 10% lower rough diamond sales volumes by De Beers and Alrosa in the first quarter. Rough diamond prices during these sights (ie sales cycles) were comparable with last year, while April prices were up 2-3% y-o-y, according to Sarine. This indicates some degree of inventory normalisation in the midstream, confirming earlier management comments. Although the situation seems to have stabilised and downstream demand remains robust, there are two downside risks worth bearing in mind. Firstly, a potential continuation of the rough diamond price increases might result in a midstream margin squeeze. However, we believe that players such as De Beers or Alrosa are less likely to push for strong rough diamond price increases without the evidence of a stronger upward trend in polished diamond prices (so far they have increased by c 3-4% ytd according to Bloomberg). Secondly, the recent fraud scandal involving the owner of Gitanjali Gems could translate into tighter bank financing and lower rough diamond allocations by main producers to Indian midstream companies, as highlighted in our last update report.

The company delivered 12 Galaxy family systems during the quarter (vs 17 systems in Q117), including five models of the recently launched Meteorite system for scanning very small rough diamonds, five Meteor models for small diamonds, one Galaxy and one Galaxy XL system. With the exception of the XL system, all were delivered in India, which represented 81% of group revenue in Q118. This has brought Sarine's installed base to 357 units as at end-March 2018 (vs 316 as at end-March 2017).Even though the segment of systems for very small diamonds constitutes the main playground for Sarine's illicit competition, the company's Meteorite systems are characterised by a clear advantage in terms of cost effectiveness (a higher-quality and faster solution at comparable pricing).

The contribution of Sarine Profile (and its components) to the company's top line remains at 2% (with management aiming at 5%). However, adoption of Sarine Profile among retailers in the Asia Pacific region continues to expand, according to the management. On the contrary, traction in the US market remains limited. Grading reports issued by the recently opened Sarine Technology Laboratory were adopted by K-Uno in mid-April and Sarine plans to open its second lab in India in May to facilitate further programme launches based on its reports in Q2/Q3. Sarine's technology is addressing a US$500m market with 7m diamond grading reports generated annually for stones from a quarter of a carat. Continued successful implementation of programmes utilising Sarine's grading reports, coupled with Sarine Profile, could translate into a further increase in the share of recurring sales in group revenues. This is particularly important, given the expected moderation of growth in equipment sales as Sarine continues to focus more on systems for smaller diamonds. Moreover, the company reiterated its earlier 2018 target of doubling the number of stones scanned by inclusion mapping systems from the 10 million reported for 2017.

Positive earnings impact from lower R&D expenses and tax rate

Gross margin remained broadly stable y-o-y at 68.2% in Q118 (compared with 67.9% in Q117), but improved sequentially from 65.4% in Q417, driven by volume growth and a more favourable product mix. R&D expenses continued to decline (down 11.6% y-o-y to US$2.7m in Q118) after peaking in H117 following the completion of investments related to Clarity and Colour grading technology and Advisor 7.0 planning software. Going forward, the company plans further upgrades to Sarine Profile, including enhanced displays, better personalisation options, as well as improved support for set jewellery pieces. Other R&D efforts include improvements to Sarine Clarity, Sarine

Colour, DiaExpert Edge, Galaxy tension mapping, as well as the introduction of the third-generation of its ultra-accurate (better than 10 micron accuracy) measurement of polished diamond proportions called Axiom.

Sales and marketing expenses remained largely flat, while G&A expenses increased 22.2% y-o-y to US$1.7m on the back of continued IP litigation costs after the temporary standstill during Diwali in Q417. Consequently, operating profit was up 12.5% with EBIT margin at 21.4% (up 192bp vs Q117). Furthermore, a more normalised effective tax rate translated into Q118 EPS growth of 27% y-o-y to 0.88 US cents.

Sarine has showed solid cash generation, with operating cash flow for the quarter at US$6.6m (vs US$4.6m in Q117), driven by stronger profitability, but also inventory reduction and higher trade payables. In conjunction with lower capex related to property, plant and equipment (PPE), this translated into a net cash position of US$35.5m by end-March 2018 compared to US$29.1m at end-2017.

Exhibit 1: Results highlights

US$000s	Q118	Q117	Y-o-y (%)
Revenues	**16,661**	**16,271**	**2.4**
Cost of sales	(5,295)	(5,219)	1.5
Gross profit	**11,366**	**11,052**	**2.8**
gross margin	*68.2%*	*67.9%*	*29bp*
Research and development costs	(2,668)	(3,018)	(11.6)
Sales and marketing expenses	(3,455)	(3,492)	(1.1)
General and administrative expenses	(1,679)	(1,374)	22.2
Operating profit	**3,564**	**3,168**	**12.5**
EBIT margin	*21.4%*	*19.5%*	*192bp*
Net finance income (expense)	24	(19)	N/M
Income taxes	(480)	(698)	(31.2)
Post-tax profit	**3,108**	**2,451**	**26.8**
Net margin	*18.7%*	*15.1%*	*359bp*
weighted diluted average number of shares ('000s)	351,332	350,719	0.2
Diluted EPS (c)	**0.88**	**0.70**	**26.5**

Source: Sarine Technologies accounts

Valuation

Sarine trades on a trailing 12-month P/E of 36.4x. Based on Bloomberg consensus for 2018 and 2019, the shares are trading on P/Es of 15.4x and 11.8x, 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 towards 2014 levels (34%) in the longer term as the company believes it has passed the peak of its current investment cycle and that 2017 was a transition year, where expenditures peaked while revenues from investments should become meaningful from 2018.

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 30-40%.

In the peer comparison table (Exhibit 2) we also show two Indian companies primarily engaged in midstream manufacturing. We note that Gitanjali Gems' multiples are depressed as a consequence of a fraud scandal associated with the company's owner. 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 (%)
		Last 12 months	2018e	2019e	2018e	2019e	2018e
Bruker Corporation	US$4,798	24.4	22.2	20.1	13.2	12.2	0.5%
Bureau Veritas	€9,543	30.8	22.1	20.4	13.7	12.8	2.7%
Spectris	US$3,478	19.4	17.7	16.4	13.6	12.7	2.2%
Intertek Group	US$8,160	28.3	25.7	23.7	15.5	N/A	1.8%
Peer group average	**-**	**25.7**	**21.9**	**20.2**	**14.0**	**12.6**	**1.8%**
Sarine Technologies	S$362	36.4*	15.4	11.8	9.3	7.3	5.1%
Premium/(discount)	**-**	**41%**	**(30%)**	**(41%)**	**(34%)**	**(42%)**	**(65%)**
Gitanjali Gems	INR463	0.3	0.2	0.2	N/A	N/A	N/A
Asian Star	INR14,714	22.4	N/A	N/A	N/A	N/A	0.2%
Chow Tai Fook	HK$104,000	58.4	25.2	21.4	17.1	14.5	N/A
Tiffany & Co	US$12,917	24.9	25.3	23.5	12.8	12.7	1.9%

Source: Company accounts, Bloomberg. Note: Prices as at 14 May 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, whose 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.

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