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SGX research scheme

Sarine Technologies

Industrials

28 February 2019

Price	S$0.40
Market cap	S$140m
	US$/S$1.35

External factors remain challenging

Sarine continued to experience more muted midstream demand in Q418, both in terms of capital equipment sales and recurring revenues. At the same time, it has kept its operating expenses under control, which allowed it to post a 6.3% y-o-y improvement in operating profit in FY18. As sales and marketing initiatives intensify in 2019 while industry challenges persist, the company has decided to temporarily reduce its dividend policy to one US cent every six months (from 2 US cents before), which still translates into a solid dividend yield at c 5% on an annualised basis.

Q418 results affected by current market conditions

Sarine reported an EBIT decline of 52% y-o-y to US$1.0m in Q418, largely due to lower revenues (-5.8% y-o-y), with both capital equipment sales and recurring revenues below last year. This is the result of continued challenges in the midstream manufacturing business associated with weaker consumer demand, tightening bank lending conditions and a weak Indian rupee, as well as the threat to smaller diamonds from lab-grown diamonds (LGD) in the market. However, in FY18, Sarine was able to improve EBIT by 6.3% on the back of lower operating costs and broadly stable revenues.

Marketing initiatives aimed at long-term growth

The company's sales and marketing expenses increased by 4.9% y-o-y to US$3.1m in Q418, which was driven by Sarine's retail-oriented business. Sarine's marketing plan for 2019 involves further showcasing the value-add of its rough diamond planning and manufacturing technology (including Advisor 8.0, which should be released in Q219 as well as Galaxy Tension Mapping). Moreover, the company's efforts will be aimed at continuing aggressive campaigns to promote the competitive advantage of its Galaxy family products (with the Meteor model campaign to be launched in Q119) and stimulating the adoption of retail-related services, especially in the Asia Pacific region.

Valuation: Revised dividend policy implies c 5% yield

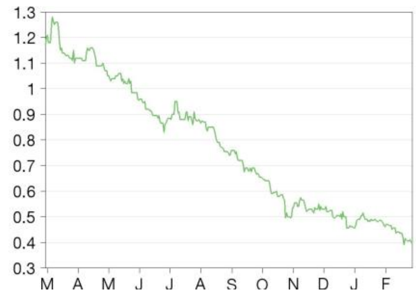
Sarine's shares currently trade at FY18 P/E and EV/EBITDA ratios of 13.7x and 6.4x, respectively. This represents a 43% and 55% discount to selected peers operating in the laboratory and site-based materials analysis and testing business, respectively. Following the temporary revision of its dividend policy, Sarine offers a prospective dividend yield of 5% on an annualised basis.

Historical financials

Year end	Revenue (US$m)	PBT (US$m)	EPS (c)	DPS (c)	P/E (x)	Yield (%)
12/15	48.5	5.3	1.03	3.00	28.8	10.1
12/16	72.5	22.0	5.14	4.50	5.8	15.2
12/17	58.6	9.4	1.64	3.50	18.1	11.8
12/18	58.5	10.1	2.17	3.00	13.7	10.1

Source: Sarine Technologies accounts.

Share price graph



Share details

Code	SARINE.SP
Listing	SGX
Shares in issue	350.6m
Last reported net cash at end-2018	US$28.9m

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 net cash position,

Bear

- Challenging environment for midstream manufacturers.
- Copyright infringement.
- Risk associated with lab-grown diamonds.

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Edison profile page

Sarine Technologies coverage is provided through the SGX research scheme.

Q418 and FY18 results highlights

Continued external pressures on the top line

Sarine reported a 5.8% y-o-y revenue decline to US$12.2m in Q418, as continued unfavourable conditions in the midstream manufacturing business in India negatively influenced both recurring revenues and equipment sales. Nevertheless, the company was able to deliver 20 Galaxy family systems in Q418, compared with 13 systems in Q318 and 11 systems in Q417 (when sales were affected by abnormally high surplus inventories of polished diamonds). This includes 16 Meteorite systems, three Galaxy systems and one Galaxy Ultra system. As a result, Sarine's installed base grew to 410 units at end-2018 compared with 345 units at end-2017. Importantly, the higher proportion of delivered systems for scanning smaller diamonds vs the prior year (six Galaxy and five Meteor systems delivered in Q417) has translated into a lower gross margin of 61.5% (vs 65.4% a year ago). Another factor reducing the margin was costs associated with the newly opened Sarine Technology Laboratories. In terms of geography, revenues in India declined 20% y-o-y to US$5.9m, while revenues in Africa and 'other' (including Russia) were up 15.0% y-o-y to US$2.3m and 82.0% y-o-y to US$2.3m, respectively.

To further stimulate the sales of its Galaxy family products, Sarine launched a marketing campaign in Q418 to strengthen the price/performance image of the Meteorite model. This will be followed by the Meteor model in Q119 and potentially by the Solaris model thereafter. In conjunction with further efforts towards showcasing its rough diamond planning and manufacturing software, as well as strengthening Sarine's downstream-related business, management expects marketing expenses to increase in FY19.

Recurring revenues (which represented c 50% of revenues in FY18) were down in Q418 due to a lower number of rough diamonds entering the pipeline. Overall, the sales volume during the last three De Beers sight cycles of 2018 increased 12.6% y-o-y, according to our estimates, but this growth was against low comparative numbers in 2017 (in particular in the eighth cycle). We also estimate that Alrosa's Q418 rough diamond sales were down 6% y-o-y despite midstream restocking in December (which was also visible during De Beers' last cycle in 2018). Importantly, there was a significant deterioration in demand for smaller, lower-priced diamonds, which seems to be a function of the introduction of lab-grown diamonds. Nevertheless, Sarine was able to improve the number of stones scanned by 20% y-o-y to 12 million in FY18, in line with earlier management guidance (with recurring Galaxy revenues up 3% y-o-y).

Retail-related revenues represented over 2% of group sales and posted nearly a 15% y-o-y increase in FY18 (somewhat below the close to 20% y-o-y growth reported in 9M18). Management emphasised that Sarine is attracting new customers for its AI-based 4Cs grading services in China, Hong King and Israel. Moreover, Sarine Diamond Journey is expanding in Japan, China, Thailand and Israel.

FY18 earnings assisted by lower R&D costs, but Q418 weak

Following the completion of important projects in 2017, R&D expenses fell 2.5% y-o-y to US$2.0m in Q418 (and by 11.8% to US$9.3m in FY18). Sales and marketing expenses grew by 4.9% y-o-y in Q418 on the back of higher third-party commission expenses related to the increase in sales outside India (which represented 51% of group sales in the quarter compared with just 43% last year). General and administrative expenses increased slightly by 2.3% y-o-y to US$1.4m as a result of higher third-party professional fees in conjunction with Sarine's ongoing IP protection measures. In conjunction with the top-line decline, the company's operating profit was down sharply by 52% y-o-y to US$1.0m in Q418. However, in FY18, operating profit was up 6.3% y-o-y to US$10.0m, assisted by broadly stable sales and lower operating expenses.

Due to a much higher effective tax rate (associated with increased tax expenses on the US$0.5m write-down of certain deferred tax assets), Sarine's post-tax profit in Q418 amounted to US$93k vs US$613k in Q417. The Board of Directors has recommended a final dividend per share for FY18 at one US cent and has also announced that the dividend policy will be temporarily revised to one US cent every six months (compared to 2 US cents previously) due to the challenging market environment, as well as increased marketing spending (as outlined earlier). At the current share price, this still represents a dividend yield of c 5% on an annualised basis.

Exhibit 1: Financial highlights

US$000s, unless otherwise stated	Q418	Q417	y-o-y	FY18	FY17	y-o-y
Revenues	**12,182**	**12,937**	**-5.8%**	**58,504**	**58,644**	**-0.2%**
Cost of sales	(4,692)	(4,479)	4.8%	(19,936)	(19,298)	3.3%
Gross profit	**7,490**	**8,458**	**-11.4%**	**38,568**	**39,346**	**-2.0%**
gross margin	*61.5%*	*65.4%*	*-389bp*	*65.9%*	*67.1%*	*-117bp*
Research and development costs	(1,964)	(2,014)	-2.5%	(9,280)	(10,519)	-11.8%
Sales and marketing expenses	(3,110)	(2,966)	4.9%	(13,263)	(13,592)	-2.4%
General and administrative expenses	(1,408)	(1,376)	2.3%	(6,019)	(5,819)	3.4%
Operating profit	**1,008**	**2,102**	**-52.0%**	**10,006**	**9,416**	**6.3%**
EBIT margin	*8.3%*	*16.2%*	*-797bp*	*17.1%*	*16.1%*	*105bp*
Net finance income (expense)	8	(89)	N/M	143	17	N/M
Income taxes	(923)	(1,400)	-34.1%	(2,547)	(3,669)	-30.6%
Post-tax profit	**93**	**613**	**-84.8%**	**7,602**	**5,764**	**31.9%**
Diluted EPS (US$ cents)	**0.03**	**0.17**	**-84.8%**	**2.17**	**1.64**	**32.0%**

Source: Sarine Technologies, Edison Investment Research

Cash balance still solid at end-2018

Sarine's net cash position remained firm at US$28.9m at end-2018 compared with US$29.1m at end-2017. Operating cash flow in FY18 amounted to US$13.9m (vs US$10.8m in FY17), assisted by prudent cost management and net working capital reduction. These cash flows were used for dividend payment and buybacks (US$12.8m in total spent in FY18) and investments (net cash flow from investing activities at US$1.8m). It is important to note that trade receivables went down to US$16.4m at end-2018 from a relatively high level of US$19.4m at end-September 2018. In Q418, allowance for doubtful trade receivables stood at US$109k compared with US$49k in Q417. Management has highlighted that payment periods are slightly longer currently, but remain in line with historical standards.

Challenges for midstream players persist

Sarine's business remains impaired by continued challenges in the midstream diamond manufacturing sector related to: 1) credit tightening and higher disclosure requirements imposed by Indian banks following the Gitanjali Gems fraud scandal; 2) deteriorating consumer demand in China on the back of the trade dispute with the US; 3) a weak Indian rupee against the US dollar, creating a working capital shortfall and affecting the profitability of Indian manufacturers with high domestic exposure; and 4) risk associated with lab-grown diamonds affecting demand for smaller, lower-value diamonds. As a result, midstream demand for rough diamonds also remained subdued at the beginning of 2019, with the first De Beers cycle in 2019 exhibiting a c 25% y-o-y decline in sales to US$505m, while Alrosa's rough diamond sales in January 2019 were down 44% y-o-y to US$282m. Importantly, January is normally a seasonally strong month, as market participants replenish their inventories after the holiday season.

It is important to note that rough diamond supply is largely controlled by three major mining companies (Alrosa, De Beers and Rio Tinto), which represent c 70% of global output. These players have recently kept the diamond supply at moderate levels. For instance, Alrosa revised its 2018 sales plan downwards to 37–38m carats (from 39–40 carats expected in June) and intends to sell only 38–39m carats in 2019, despite having the ability to sell 41m carats. Simultaneously, De Beers' sales volumes declined by 2% in FY18 to 31.7m carats. In the long term, even though supply of rough diamonds is likely to turn negative by 2020, this is largely attributable to sub-par quality brown diamonds in the Argyle deposit. On the other hand, new attractive diamond deposits are becoming more difficult to find.

Margin pressure on the midstream manufacturers is thus likely to continue at least into early 2019, as rough diamond prices remain relatively high while polished diamond price growth is limited by more moderate demand. For the full year, Paul Zimnisky expects nominal jewellery demand growth at 3.5%, which should translate into low- to mid-single digit percentage growth in polished diamond prices.

Valuation

Sarine's valuation and upside is mainly dependent on improvement in the midstream diamond manufacturing sector, as well as the company's expansion in the downstream segment, which should further support earnings growth, and improvements in profitability and returns. We believe that ROE has scope to improve at least partially towards 2014 levels (34% vs current LTM ROE of c 11%) in the longer term, as R&D expenditure has already peaked, while revenues from investments should become meaningful. However, the current unfavourable market environment means this is unlikely to happen in the immediate future.

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 (for a detailed description, please refer to our previous update note). Although we acknowledge that these companies operate in different markets from Sarine, we have identified some similarities to Sarine's activities.

Sarine trades on a 2018 P/E of 13.7x when adjusted for the US$0.5m write-down of deferred and other tax assets recognised in Q418. This translates into a 43% discount to the peer group. At present, there is no Refinitiv consensus available for the company.

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 over 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 P/E ratios. The premiums are likely a reflection of their very strong brands and market positions in jewellery retailing.

Exhibit 2: Peer group comparison

	Market cap	P/E (x)			EV/EBITDA (x)			Dividend yield (%)
	(local ccy m)	2018e	2019e	2020e	2018e	2019e	2020e	2018e
Bruker Corporation	US$5,951	33.1*	24.3	22.0	18.2*	15.1	13.8	0.4%
Bureau Veritas	€8,673	20.8	20.4	19.0	11.3	12.3	11.5	2.8%
Spectris	US$3,059	16.5*	15.0	14.0	11.8*	11.0	10.2	2.2%
Intertek	US$8,254	26.4	25.8	23.9	15.2	15.2	14.0	1.4%
Peer group average	**-**	**24.2**	**21.4**	**19.7**	**14.2**	**13.4**	**12.4**	**1.7%**
Sarine Technologies	S$140	13.7*	N/A	N/A	6.4*	N/A	N/A	8.8%
Premium/(discount)	**-**	**(43%)**	**N/A**	**N/A**	**(55%)**	**N/A**	**N/A**	**N/M**
Chow Tai Fook	HK$74,300	17.7*	17.0	15.5	11.7*	10.9	16.6	3.6%
Tiffany & Co	US$11,461	18.9	19.7	18.9	11.5	11.3	19.0	2.1%

Source: Company accounts, Refinitiv consensus as at 26 February 2019. Note: *Based on reported numbers. Sarine's FY18 P/E is adjusted for the US$0.5m write-down of deferred and other tax assets.

EDISON

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