EDISON

SGX research scheme

Sarine Technologies

Industrials

22 November 2018

Navigating through a difficult environment

Sarine's top-line growth continues to be affected by the multiple challenges the midstream diamond business is currently facing, which impair the sector's cash generation (and Sarine's equipment sales). Having said that, scanning activity remains at record-high levels and management expects the number of scanned stones to increase by 20% in 2018. Moreover, corporate overheads and R&D expenses are being kept below last year. In the long term, lab-grown diamonds represent both a risk (which is however difficult to quantify currently) and an opportunity to Sarine's business.

Profitability assisted by reduced operating costs

Sarine reported an EBIT of US$760k in Q318 (vs a small loss of US$11k in Q317) on the back of lower R&D, sales and marketing, as well as G&A expenses. Sales grew by 3.7% y-o-y to US$11.7m despite the downward trend in rough diamond purchases in the market, as recurring revenues (nearly 50% of group sales in 9M18) increased on the back of a growing installed base of Galaxy family systems (390 at end-September 2018 vs 330 at end-September 2017). Retail-related sales were up almost 20% y-o-y in 9M18 and made up more than 2% of group sales.

Midstream players facing multiple headwinds

Sarine's performance is currently shaped by several external factors which affect the midstream industry in India. These include: 1) declining luxury goods sales in China amid the trade war with the US; 2) tightening bank lending as a result of the Gitanjali Gems scandal; and 3) Indian rupee depreciation creating a working capital shortfall. As a result, the cash flow situation of manufacturers has deteriorated visibly. Investor sentiment is also influenced by the uncertainties around the potential long-term impact of lab-growth diamonds (LGD) on the industry.

Valuation: Discount reflects external pressures

Based on Thomson Reuters consensus, Sarine's shares currently trade at FY18e and FY19e P/E ratios of 7.7x and 5.5x, respectively. This represents a 62% and 70% discount to selected peers operating in the laboratory and site-based materials analysis and testing business, respectively. However, this is based on the high EPS growth expectations embedded in the current consensus figures (which are calculated based on two analysts only). We believe the discount reflects the current challenging conditions in Sarine's end-market.

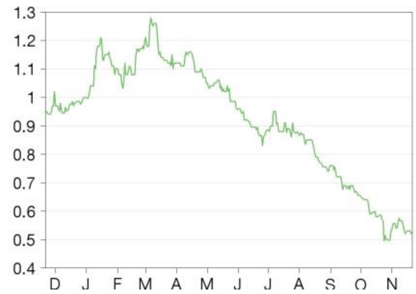
Consensus estimates

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	7.5	11.6
12/17	58.6	9.4	1.64	3.50	23.6	9.0
12/18e	74.8	21.7	5.00	N/A	7.7	N/A
12/19e	85.0	28.4	7.00	N/A	5.5	N/A

Source: Sarine Technologies, Thomson Reuters consensus as at 20 November 2018.

Price	**S$0.53**
Market cap	**S$185m**
	US$/S$1.37

Share price graph



Share details

Code	SARINE.SP
Listing	SGX
Shares in issue	350.6m
Last reported net cash at 30 September 2018	US$25.3m

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 net cash position.

Bear

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

Analyst

Milosz Papst +44 (0)20 3077 5700

industrials@edisongroup.com

Edison profile page

Sarine Technologies coverage is provided through the SGX research scheme.

Financials: Top line limited by external factors

Sarine reported modest revenue growth of 3.7% y-o-y to US$11.7m in Q318, despite a low base from Q317. On top of the usual seasonal slowdown in Q3, the company's business was also affected by subdued industry sentiment (discussed later in the note). This is illustrated by the relatively weak sales volume at De Beers sights, which was down 2.2% y-o-y on a cumulative basis in the first seven cycles (with the provisional data for the eighth cycle showing an increase largely due to a low base effect from last year). As prices of rough diamonds continue to rise at a low single-digit pace y-o-y (putting some pressure on midstream margins), this implies a decline in the volume of rough diamonds being purchased. Despite this, Sarine's scanning activity remains solid and the company declared that it should post 20% growth in the number of scanned stones in FY18. Another minor positive factor is that the midstream industry entered Q318 with a more moderate inventory base of rough and polished diamonds (Q218 at US$41.8bn vs US$42.6bn at Q217, according to Alrosa estimate).

Top-line growth was mainly assisted by recurring revenues, which stood at just under 50% in 9M18 (vs 46% in 9M17). Galaxy-related recurring sales increased 6% y-o-y in Q318, assisted by the growth in installed base to 390 units at end-September 2018 (vs 330 at end-September 2017). Equipment sales were flat y-o-y, as the company delivered 13 Galaxy family systems in Q318, including 11 Meteorite models, one Meteor and one Galaxy system. In line with prior quarters, sales of equipment for scanning smaller stones is a major contributor, with all these systems delivered to Indian customers. This is a sign that Sarine's efforts to combat illicit competition are showing results, according to the company. Retail-related sales (mainly Sarine Profile) were up nearly 20% in 9M18 (vs 25% y-o-y in H118) and made up more than 2% of group revenue (vs c 2% last year).

Gross profit improved slightly by 1.5% y-o-y to US$7.5m, as revenue growth was accompanied by a negative sales mix effect and additional costs associated with the newly opened laboratories in Israel and India (Ramat Gan and Mumbai). Consequently, gross margin stood at 64.3% compared with 65.7% in Q317. However, Sarine continued to keep its other expenses below last year, with R&D costs down 9.7% y-o-y to US$2.2m, or down 22.6% y-o-y taking into account the capitalised costs associated with the development of Sarine Clarity and Sarine Colour systems last year. At the same time, sales and marketing expenses were down 7.4% y-o-y to US$3.1m (due to lower compensation expenses amid continued staff restructuring) and G&A expenses declined by 10.7% to US$1.4m (also due to lower salary expenses, including a reversal of some incentive-based compensation expenses). Consequently, Sarine was able to record an EBIT of US$760k (compared with a minor loss of US$11k in Q317). This, together with a more normalised tax rate (amid the lack of US$0.3m write-down of deferred and other tax assets last year), translated into Q318 EPS at 0.08 US cents compared with a negative 0.15 US cents in Q317.

Exhibit 1: Financial highlights

US$000s	Q318	Q317	y-o-y
Revenues	**11,702**	**11,285**	**3.7%**
Cost of sales	(4,174)	(3,870)	7.9%
Gross profit	**7,528**	**7,415**	**1.5%**
Gross margin	*64.3%*	*65.7%*	*-138bp*
Research and development costs	(2,194)	(2,430)	-9.7%
Sales and marketing expenses	(3,142)	(3,393)	-7.4%
General and administrative expenses	(1,432)	(1,603)	-10.7%
Operating profit	**760**	**(11)**	**N/M**
EBIT margin	*6.5%*	*-0.1%*	*659bp*
Net finance income (expense)	24	53	-54.7%
Income taxes	(515)	(572)	-10.0%
Post-tax profit	**269**	**(530)**	**N/M**
Diluted EPS (US$ cents)	**0.08**	**(0.15)**	**N/M**

Source: Sarine Technologies, Edison Investment Research

Trade receivables increased by 18.1% y-o-y to US$19.3m and, although they were below Q218 (US$20.2m vs US$17.6m in Q217), they remained at a relatively high level. This seems to be associated with the tight cash flow situation of selected customers and the overall increase in recurring revenues. Moreover, Sarine has booked US$91k in doubtful trade receivables in Q318 (US$100k in 9M18). However, the sequential decline of US$0.9m had a positive effect on Q318 cash flow, which (together with the US$269k net income) translated into cash flows from operations at US$665k (compared with negative US$1,126k in Q317). The company also recognized positive investing cash flow at US$3.3m as a result of cash release from bank deposits. This was more than offset by the dividend payment of US$7.0m and translated into a net decline in cash of US$3.2m to US$14.1m. When adding short-term investments representing bank deposits, Sarine's liquid assets stood at a solid US$25.3m vs US$29.1m at end-2017. The company continues its buyback programme, with 152,900 shares purchased in Q318, bringing the ytd number to 746,400 (or 0.2% of shares outstanding at end-2017).

Midstream diamond industry remains under pressure

Currently, the midstream industry in India is negatively affected by several factors. Firstly, trade tariffs imposed on China had a negative impact on the Chinese economy, including a c 20–25% decline in luxury goods consumption. Secondly, the recent credit tightening introduced by Indian banks (primarily as a result of the Gitanjali Gems scandal) is translating into cash flow problems for some midstream players. The FX market is causing additional headwinds, with the Indian rupee depreciating by c 10% against the US dollar ytd. As Indian manufacturers' foreign currency export credits are pegged to the Indian rupee and imported rough stones are priced in US dollars, the depreciating local currency has translated into a working capital shortfall. The Gem & Jewellery Export Promotion Council has recently approached the government, suggesting that these credits should be pegged to US dollar instead.

The market also seems to be concerned about the long-term impact of lab-grown diamonds (LGDs) on the diamond industry. De Beers has recently launched its Lightbox line of jewellery based on LGDs, priced as fashion jewellery (ie some 80% below natural diamonds). Moreover, the US Federal Trade Commission has updated its definition of a diamond to include LGD (although it requires that their non-natural origin is clearly labelled). The key competitive edge of lab-grown diamonds is their lower price point vs natural diamonds. However, the actual impact of LGDs on the industry is difficult to assess at the moment. Firstly, it remains to be seen what part of the customer base will consider the attractive pricing a more important factor than the distinct image of natural diamonds (which justifies a certain premium). In addition, a portion of LGDs falls into the fashion jewellery market rather than the higher-quality diamond jewellery market, so would not represent a direct competition to diamond jewellery. It is possible that the customers' decisions will depend on the occasion for buying a diamond, with special events such as engagement/wedding encouraging customers to prefer natural diamonds. On the other hand, some consumers (especially millennials) may choose LGDs over natural diamonds for environmental, social and governance (ESG) reasons.

According to Paul Zimnisky (an independent industry analyst and consultant), LGD sales should grow from around US$2.0bn in 2018 to US$5.0bn in 2023 (ie at a 22% CAGR) and to US$15.0bn in 2035. This would imply a market share of 3% in 2023 and 5% in 2035 of the overall diamond jewellery market, suggesting that LGD will remain a meaningful, but still limited part of the overall market. It is also important to note that the LGD industry could become a customer for Sarine, especially in the case of diamond producers that use the (currently dominant) high-pressure/high-temperature (HPHT) technology, which requires more inclusion scanning and planning processes compared to the alternative chemical vapour deposition (CVD) technology. With respect to the latter, it still creates a market for Sarine's laser cutting systems. Sarine Profile should remain largely unaffected, as it addresses polished diamonds over 20 points (ie 0.2 of a carat), whereas the average size of LGD is lower and the maximum size is limited by technological constraints. In fact, LGD constitute a new market opportunity for Sarine's 4Cs grading services.

Valuation

Sarine trades on a trailing 12-month P/E of 14.9x (when adjusted for the US$1.0m write-down of deferred and other tax assets recognised in Q417). Based on Thomson Reuters consensus figures for 2018 and 2019, the shares are trading on P/E ratios of 7.7x and 5.5x, respectively, with expected y-o-y EPS growth of c 160% (on an adjusted basis) and 40%, 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 of c 12%) 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 nearest 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 (see detailed descriptions below). Sarine is trading at a discount to this peer group on P/E ratios of c 60–70%.

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

Exhibit 2: Peer comparison

	Market cap	P/E (x)		EV/EBITDA (x)		Dividend yield (%)
	(LCYm)	2018e	2019e	2018e	2019e	2018e
Bruker Corporation	US$5,093	23.3	21.0	14.1	13.2	0.5%
Bureau Veritas	€8,604	20.2	18.6	12.2	11.5	3.0%
Spectris	US$2,455	13.8	12.5	9.1	8.4	2.9%
Intertek	US$7,321	23.1	21.3	13.5	12.5	2.1%
Peer group average	-	**20.1**	**18.4**	**12.2**	**11.4**	**2.1%**
Sarine Technologies	S$186	7.7	5.5	N/A	N/A	N/A
Premium/(discount)	**-**	**(62%)**	**(70%)**	**N/A**	**N/A**	**N/A**
Chow Tai Fook	HK$70,500	14.5	12.8	11.6	9.6	5.2%
Tiffany & Co	US$13,036	22.0	19.5	13.1	12.2	2.1%

Source: Company accounts, Thomson Reuters. Note: Prices as at 19 November 2018.

General disclaimer and copyright

Australia

New Zealand

United Kingdom

United States