

# Sarine Technologies

Industrials

05 March 2018

## Capital equipment sales gradually recovering

Sarine's FY17 results were under pressure from excessive polished diamond inventories in H217 and continued illicit competition in India. However, Q417 saw a sequential increase in capital equipment sales, with 11 Galaxy family systems delivered during the quarter and a total installed base of 345 systems as at end-2017 vs 299 in 2016. Midstream inventory levels seem to have normalised and scanning activity is picking up. Management confirmed its positive consumer demand outlook for FY18.

## Market conditions weighing on y-o-y performance

Sarine reported a Q417 EPS of US\$0.17 (down from US\$1.42 in Q416), which was driven by lower capital equipment sales, reduced gross margin (mostly due to lower volumes) and G&A costs that were 24% higher y-o-y reflecting continued IP litigation. The stronger Israeli shekel was responsible for a c 10% EBIT decline. The company also booked a US\$1.0m write-down of deferred and other tax assets. Group sales in Q417 increased 14.6% vs Q317, but remained 31.6% below the previous year. R&D costs continued to decline after peaking in H117, with major projects already completed.

## Reduced inventories bode well for Q118

Following the considerable midstream overstocking in Q2 and Q3 last year, management believes that inventory levels have normalised somewhat towards the end of 2017 on the back of strong year-end holiday season sales (+5.8% y-o-y in the US) and a positive outlook for the Chinese New Year and Valentine's Day sales. This seems to be confirmed by the favourable trend in scanning activity reported by Sarine, with an FY18 target set at doubling the number of scanned stones (over 10 million in FY17). However, some downside risk comes from the potential impact of the recent fraud scandal involving the owner of Gitanjali Gems, which may result in tighter bank financing and lower rough-diamond allocations made by main producers to Indian midstream companies (which represented nearly 70% of Sarine's group sales in FY17).

## Valuation

Sarine's shares currently trade at FY18e and FY19e P/E ratios of 17.9x and 13.8x, representing a 20% and 32% 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 cents (US\$) in FY18e and 6.5 cents in FY19e (with one not yet adjusted following the Q3 results).

| 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    | 17.4    | 5.0       |
| 12/17               | 58.6            | 9.4         | 1.64    | 3.50    | 54.5    | 3.9       |
| 12/18e              | 74.8            | 21.7        | 5.00    | 3.90    | 17.9    | 4.4       |
| 12/19e              | 85.0            | 28.4        | 6.50    | 4.80    | 13.8    | 5.4       |

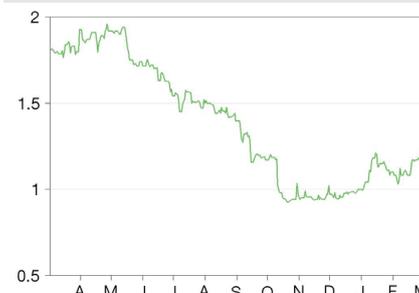
Source: Sarine Technologies accounts, Bloomberg consensus as at 1 March 2018.

Price **\$S1.18**

Market cap **\$S415m**

US\$/S\$1.32

### Share price performance



### Share details

|                 |           |
|-----------------|-----------|
| Code            | SARINE.SP |
| Listing         | SGX       |
| Shares in issue | 351.1m    |

### 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\$29.1m).

### Bear

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

### Analysts

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## Financials: Sequential results recovery in Q417

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Sarine's FY17 EPS came in at US\$1.64 and was considerably below the previous year (US\$5.14), with Q417 EPS of just US\$0.17 (Q416: US\$1.42). Group revenue remained 31.6% below Q416, translating to an FY17 sales decline of 19.1% y-o-y. Sales of capital equipment were negatively affected by abnormally high surplus inventories of polished diamonds in H217 and illicit competition in India. Both factors were already highlighted in Q317 and continued through mid-December 2017. That said, there was also a visible sequential improvement in business sentiment and capital equipment sales, which resulted in Sarine's revenue increasing in Q417 by 14.6% vs Q317. Muted Q417 sales of rough diamonds by key producers (De Beers, Alrosa), as well as flat rough prices, may indicate a normalisation at the midstream level. Moreover, shortages of certain categories of polished diamonds are becoming visible. In addition, it is worth noting that FY16 was a particularly strong year in terms of capital equipment sales amid low polished diamonds inventory at the midstream level by end-2015, coupled with a favourable price relationship between rough and polished diamonds that drove midstream profitability. Sarine's installed base of Galaxy family systems reached 345 at end-2017, with 11 systems delivered in Q417 (including six Galaxy and five Meteor systems). This compares with 24 systems in Q416 and an average of c 11-12 systems delivered during the fourth quarter in the period 2013-2015.

Recurring income remained solid at nearly 50% of group revenues in FY17, compared with c 40% in FY16, although the higher share was to some extent a function of lower equipment sales compared to the previous year. The company has reached its milestone of 10 million stones scanned in a single year and now aims at doubling the number in FY18, and trebling the associated revenues on the back of higher average prices. This should be assisted by the increased adoption of an attractively priced, comprehensive service package for retailers consisting of Sarine Profile, AI-based 4C grading reports (the company opened its new lab in February this year), Sarine's light performance grading and the recently introduced Sarine Diamond Journey. So far, Sarine Profile's contribution remained at 2% of group sales (behind the previous expectations highlighted in the FY16 report of 5%). The company was recently able to attract two Chinese chain retailers (JAFF and JASS, launching Sarine Profile after the Chinese New Year) and also anticipates increased adoption through 10 new programmes that are currently being initiated or expanded.

Group gross margin in Q417 reached 65.4%, which is below Q416 (71.7%) due to lower volumes and also slightly behind Q317 (65.7%) as a result of less favourable product mix. Sarine's G&A costs increased 24% y-o-y (due to ongoing IP litigation), but were 14% lower than in Q317 on the back of lower third-party professional fees, as court-related IP protection activities came to a standstill during Diwali, and amid a reversal of accrued incentive-based compensation. R&D expenses continue to decline after the peak in H117, with US\$2.0m booked in Q417 (17% below the US\$2.4m recorded in Q317), as most of the expenses related to Clarity and Colour grading technology and Advisor 7.0 planning software were already incurred. Despite pre-tax profit being around two-thirds lower, the income tax charge was c 9% higher y-o-y in the quarter, as it included a US\$1.0m write-down of certain deferred and other tax assets.

Sarine retained a solid net cash position of US\$29.1m (up from US\$27.8m at end-September 2017) and recommended a final dividend distribution of US\$1.50 (payable on 10 May). Including the interim dividend already paid, the aggregate distribution would reach US\$12.3m (vs FY17 operating cash flow of US\$10.8m) or US\$3.50 per share (compared to US\$4.50 paid out of 2016 earnings).

**Exhibit 1: Results highlights**

| in US\$000s                                      | Q417          | Q416          | y-o-y (%)     | FY17          | FY16          | y-o-y (%)     |
|--|---------------|---------------|---------------|---------------|---------------|---------------|
| <b>Revenues</b>                                  | <b>12,937</b> | <b>18,917</b> | <b>(31.6)</b> | <b>58,644</b> | <b>72,524</b> | <b>(19.1)</b> |
| Cost of sales                                    | (4,479)       | (5,346)       | (16.2)        | (19,298)      | (22,235)      | (13.2)        |
| <b>Gross profit</b>                              | <b>8,458</b>  | <b>13,571</b> | <b>(37.7)</b> | <b>39,346</b> | <b>50,289</b> | <b>(21.8)</b> |
| <i>Gross margin (%)</i>                          | 65.4          | 71.7          | (636bp)       | (67.1)        | (69.3)        | (225bp)       |
| Research and development costs                   | (2,014)       | (2,714)       | (25.8)        | (10,519)      | (10,844)      | (3.0)         |
| Sales and marketing expenses                     | (2,966)       | (3,469)       | (14.5)        | (13,592)      | (13,578)      | 0.1           |
| General and administrative expenses              | (1,376)       | (1,110)       | 24.0          | (5,819)       | (4,657)       | 25.0          |
| <b>Operating profit</b>                          | <b>2,102</b>  | <b>6,278</b>  | <b>(66.5)</b> | <b>9,416</b>  | <b>21,210</b> | <b>(55.6)</b> |
| Net finance income (expense)                     | (89)          | (2)           | n.m.          | 17            | 755           | n.m.          |
| Income taxes                                     | (1,400)       | (1,287)       | 8.8           | (3,669)       | (3,985)       | (7.9)         |
| <b>Post tax profit</b>                           | <b>613</b>    | <b>4,989</b>  | <b>(87.7)</b> | <b>5,764</b>  | <b>17,980</b> | <b>(67.9)</b> |
| <i>Net margin (%)</i>                            | 4.7           | 26.4          | n.m.          | 9.8           | 24.8          | n.m.          |
| Weighted diluted average number of shares (000s) | 350,988       | 350,300       | 0.2           | 351,259       | 350,067       | 0.3           |
| <b>Diluted EPS (US\$ cents)</b>                  | <b>0.17</b>   | <b>1.42</b>   | <b>(87.7)</b> | <b>1.64</b>   | <b>5.14</b>   | <b>(68.0)</b> |

Source: Sarine Technologies accounts, Edison Investment Research

## Valuation

Sarine trades at a trailing 12-month P/E of 47.4x. Based on Bloomberg consensus for 2018 and 2019, the shares are trading at a P/E of 17.9x and 13.8x, 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, with one not yet adjusted following the Q3 results.

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. ROE has scope to improve towards 2014 levels (34%) as the company believes it has passed the peak of its current investment cycle and that 2017 represents a transition year, where expenditures peak 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 than Sarine, we identified some similarities to Sarine's activities. Sarine is trading at a discount to this peer group on both P/E and EV/EBITDA ratios of c 15-30%.

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 karat 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 is 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 that comprehensively delineates physical objects and is accurate to one ten-thousandth of an inch.

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) | P/E (x)        |              |              | EV/EBITDA (x) |              | Dividend yield (%) |
|---------------------------|----------------|----------------|--------------|--------------|---------------|--------------|--------------------|
|                           |                | Last 12 months | 2018e        | 2019e        | 2018e         | 2019e        | 2018e              |
| Bruker Corporation        | US\$4,894      | 24.9           | 22.6         | 20.5         | 14.4          | 13.3         | 0.5%               |
| Bureau Veritas            | €9,471         | 23.1           | 22.0         | 20.3         | 13.2          | 12.2         | 2.8%               |
| Spectris ADR              | £3,248         | 18.5           | 17.6         | 16.2         | 15.5          | 13.8         | 2.0%               |
| Intertek Group            | £7,998         | 26.0           | 29.3         | 26.2         | 15.0          | N/A          | 1.5%               |
| <b>Peer group average</b> | -              | <b>23.1</b>    | <b>22.9</b>  | <b>20.8</b>  | <b>14.5</b>   | <b>13.1</b>  | <b>1.7%</b>        |
| Sarine Technologies       | SG\$425        | 47.4*          | 18.3         | 14.1         | 12.0          | 9.5          | 4.3%               |
| <b>Premium/(discount)</b> | -              | <b>105%</b>    | <b>(20%)</b> | <b>(32%)</b> | <b>(17%)</b>  | <b>(28%)</b> | <b>(60%)</b>       |
| Gitanjali Gems            | INR2,402       | 1.4            | 1.1          | 0.9          | N/A           | N/A          | N/A                |
| Asian Star                | INR19,495      | 29.6           | N/A          | N/A          | N/A           | N/A          | 0.1%               |
| Chow Tai Fook             | HK\$86,300     | 27.3           | 21.4         | 18.8         | 14.9          | 12.9         | N/A                |
| Tiffany & Co              | US\$12,569     | 26.0           | 24.7         | 23.2         | 12.5          | 12.3         | 1.9%               |

Source: Company accounts, Bloomberg consensus as at 1 March 2018. Note: \*Adjusted for the US\$1.0m write-down of deferred and other tax assets.

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