

Serial System Ltd

All Systems OK & Going for TDR Listing

Serial System Ltd's (Serial) 3Q FY10 results showed that the company is still on the growth track. We continue to be sanguine on Serial's prospects. We see its proposed listing of Taiwan Depository Receipts (TDRs) as a possible catalyst for value discovery if successful. **Maintain Increase Exposure view on an intrinsic value of S\$0.200.**

Key Developments:

- 3Q FY10 revenue grew by 16.6% YoY on the back of strong growth in key markets like China. Having committed significant investments in China in recent years, Serial seems to be reaping the benefits of these capital outlays now.
- 3Q FY10 PATMI grew by 41.4% YoY as a result of rising economies of scale. Going forward, the company intends to focus on maximizing the revenue potential of its network of sales offices and relationships in China.
- Other growth areas include Taiwan and India, where Serial has relatively low bases. We see continued expansion in these countries as efforts by the company to set up the stage for its next phase of growth.
- Serial recently announced that it is considering listing TDRs on the Taiwan Stock Exchange. Not only will the listing raise new funds to support business expansion, it will provide Serial with higher visibility in Taiwan.

Outlook:

Serial's credible performance in 2010 is evidence of its execution ability. This in turn raises our confidence in the company's prospects. We also noted that Serial has been aggressive in enhancing shareholder value, with a dividend payout ratio of 40% to 50% each year. Serial is also considering listing TDRs, which may boost its share price if successful.

Increase Exposure

- Intrinsic Value S\$0.200
- Prev Close S\$0.160

Main Activities

Serial System Ltd is principally engaged in the semiconductors and components distribution business. Its geographical presence extends to Singapore, PRC, Hong Kong, Korea, Taiwan, Malaysia, Thailand, Philippines, India and Vietnam.

Financial Highlights

(Y/E Dec) S\$m	FY08	FY10	FY10F
Revenue	510.6	556.5	751.6
Gross Profit	46.7	48.6	72.4
Earnings	6.0	7.5	14.7
EPS (S cts)	1.0	1.1	1.9

Source: Company, SIAS Research

Key ratios (FY10F)

PER	8.5
P/BV	1.16
Return on Common Equity^	14.4%
Gross Debt to Common Equity	9.0%
Current ratio	1.6

^Assumes the full conversion of outstanding warrants

Source: SIAS Research

Indexed Price Chart

Green (FSSTI)

White (SERL)



Source: Bloomberg

52wks High-Low	S\$0.185 /S\$0.060
Number of Shares	757.3m
Market Capitalization	S\$121.2m

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Performance Overview

Serial System Ltd (Serial) held a briefing on 14 October 2010 to update analysts on its 3Q FY10 performance. These are our key takeaways:

Still going strong. Serial's sales and net profit are still seeing sequential growth, demonstrating that the company is still on track for expansion. PATMI and revenue grew by 13.9% and 3.4% respectively QoQ. YoY, bottom-line expanded by 44.0%, while sales increased by 16.6%.

While 3.4% might seem slow, we noted, as an example, that eight consecutive quarters of similar growth would have resulted in sales in the second year being 14.3% higher than that in the first.

Figure 1: Results Overview

	3Q FY09	2Q FY10	3Q FY10	Growth	
				YoY	QoQ
Revenue	167.4	188.7	195.2	16.6%	3.4%
Gross Profit	15.3	19.1	18.8	22.9%	-1.6%
EBITDA	5.0	6.4	7.2	44.0%	12.5%
PATMI	2.9	3.6	4.1	41.4%	13.9%
				Chg	
	3Q FY09	2Q FY10	3Q FY10	YoY	QoQ
Gross Margin	9.1%	10.1%	9.6%	0.5%	-0.5%
EBITDA Margin	3.0%	3.4%	3.7%	0.7%	0.3%
PATMI Margin	1.7%	1.9%	2.1%	0.4%	0.2%

Source: Company, SIAS Research

Greater China market showed strong growth. The Greater China segment, representing the Hong Kong and Mainland China territories grew by S\$11.3m YoY, accounting for 40.6% of growth. According to Management, the Taiwan market also showed strong growth.

Good results driven by smooth execution of strategy. Management explained that their strategy of targeting the 2nd and 3rd tier manufacturers in China has been showing results. Serial's strong relationship with these customers, as well as those in Taiwan, has allowed the company to capture more business from them.

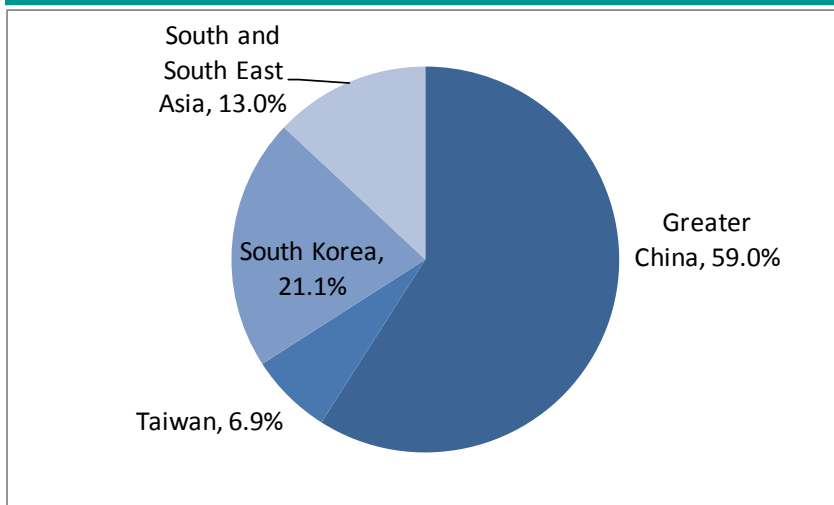
Particularly, Serial is able to maintain a strong relationship with its customers in China as it has invested in the infrastructure to create an extensive network of 24 sales offices in the mainland, where more than half of its headcount is located.

In addition, Serial has also garnered more orders from the 1st tier customers such as Haier and Changhong, major white goods producers in China, implying that the company is gaining not only volume from the overall market, but also acceptance by significant players.

We believe that customers are also more willing to work with Serial as it is backed by a strong set of product line cards, giving it an extensive range of products. We are probably seeing now the results of Serial being awarded the distribution rights to Tyco Electronics' products in China, Hong Kong and South Korea back in October 2009.

Economies of scale drove margin expansion. PATMI also widened by 0.2% points to 2.1% from 1.9%. Accordingly, Serial's investments in China are now of significant scale for the company to reap economies of scale from its operations there. In turn, this gives Serial the headroom to reinvest its profit in new target markets. We suspect that product mix improvements also contributed towards the higher margin achieved.

Figure 2: Revenue Mix by Geography (3Q FY10)



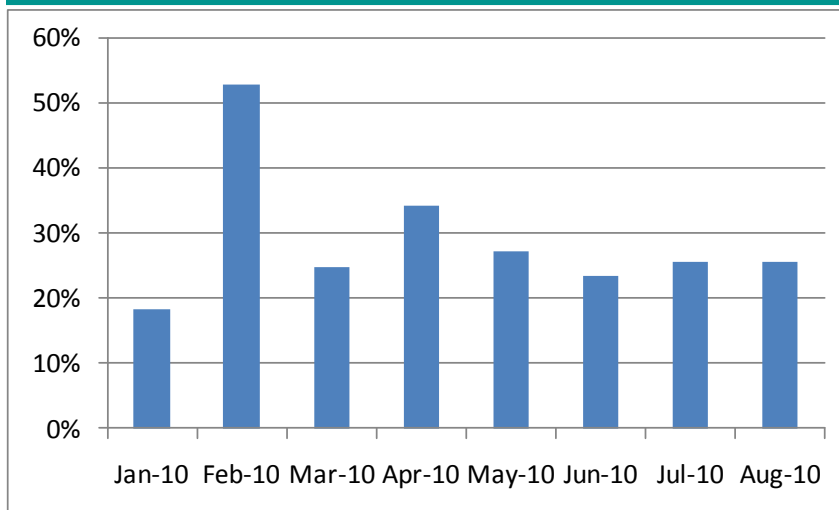
Source: Company, SIAS Research

No balance sheet was presented as Serial is not required to formally announce 3Q results. The briefing was more of a performance update to stakeholders. Accordingly, gearing was in the range of 70% to 80%.

Outlook

Continue to focus on North Asia. Going forward, the company intends to maximize the revenue potential of its network of sales offices in China. We continue to be sanguine on the China domestic economy. Rising minimum wages and urbanization suggest strong demand for electronic and electrical products. China retail sales of household appliances and AV equipment grew by 25.6% YoY to RMB31.7bn in August 2010. Over the same period, sales of communication devices increased by 21.9% to RMB7bn.

Figure 3: China Retail Sales Growth (Household Appliances and AV Equipment)



Source: Company, SIAS Research

Other initiatives include continued expansion in Taiwan and increased penetration into the India market. In the first nine months of 2010, Serial earned just S\$5.8m of revenue from India. We opine that India is the company's long term growth solution beyond China, Taiwan and North Korea.

Despite the encouraging performance in 3Q FY10, we do not expect to continue observing sequential growth in 4Q FY10. Due to seasonal factors, sales might slow by up to 5% QoQ in 4Q FY10. However, this scenario will still result in 15.8% YoY sales growth for the company.

Key risks against our view include that of an unanticipated downturn in the electronics components industry and excess inventory among customers. These risks are mitigated by Serial's focus on the Asia-Pacific region, which is expected to grow faster than US and Europe in the long term. In addition, Serial supplies to multiple industries, including medical equipment, communication devices and consumer electronics.

Forecasts, Valuation and Dual Listing Effects

We shaved our FY10F revenue forecast for Serial to S\$751.6m, from S\$779.1m previously. However, FY10F PATMI is raised to S\$14.7m from S\$13.6m in our last update, to reflect Serial's higher margin. Our profit forecast implies a net margin of about 2.2% in 4Q FY10F, which is reasonable as the company reported a net margin of 2.1% in 4Q FY09 on revenue that is estimated to be 13.7% lower than that of this year (lower economies of scale).

Our FY11F and FY12F top-line forecasts remain unchanged. However, the increased expected profitability pushed our valuation of Serial upwards to S\$0.200 a share (previously S\$0.180), implying a positive value-price gap of 25.0%.

A lower cost of capital also resulted in the higher valuation despite our assumption of an enlarged share capital. Our valuation model presumes that a) Serial's 67.4m of outstanding warrants will be converted by the end of this year, and that b) the company will issue an estimated 90.1m shares or 11.9% of its existing share capital for its proposed TDR listing.

Our set of Taiwan listed peers have a T12 PER of 11.4x. Assuming a similar valuation multiple, Serial's TDRs may be issued at a price of up to S\$0.175 (11.4 x 'post-TDR and warrants conversion' T12 EPS of 1.53 S cents) each or a premium of up to 9.4%. If successful, the TDRs might be listed by early 2011. We believe that the successful listing of the TDRs has the potential effect of lowering Serial's cost of capital and be a catalyst for value discovery. However, we caution that Serial's share price may be adversely affected if the proposed TDR listing fails.

The proceeds of the TDRs will probably be used to pay off existing debt or be used to fund daily business operations, given Serial's current debt level and working capital intensive nature. In turn, this gives Serial financial headroom to grow. Nonetheless, we do not rule out the possibility of investments in or acquisitions of smaller sized peers as the electronics distribution industry is undergoing a consolidation phase. A well selected investment will exponentially increase Serial's presence in its intended market.

Serial currently trades at 9.4x T12 PER, based on an estimated 12M EPS of 1.7 S cents a share as of 3Q FY10, where we assumed the full conversion of in-the-money warrants, but excluded the impact of any new shares issued from the TDR listing. Our intrinsic value of S\$0.200 translate to a FY10F and FY11F PER of 10.6x and 8.9x respectively.

Maintain Increase Exposure view with an intrinsic value of S\$0.200, representing an implied positive value-price opportunity of 25.0%.

Figure 4: Economic Profit Valuation Model

S\$ m	FY10F	FY11F	FY12F
Revenue	751.6	934.9	1075.1
EBIT	23.1	29.7	33.9
Tax on EBIT	-6.9	-8.9	-10.2
NOPLAT	16.2	20.8	23.7
Invested Capital	139.9	192.3	227.3
% of Debt	33.2%	40.7%	38.7%
% of Equity	66.8%	59.3%	61.3%
WACC (%)	7.9%	7.3%	7.4%
Capital Charge	11.1	14.0	16.9
Economic Profit	5.1	6.8	6.8
Terminal Value			79.6
Discount Rate	1.0	0.9	0.9
Present Value	5.0	6.3	5.8
Book Value	96.6	Risk Free Rate	1.96%
Explicit Value	17.1	Beta	1.00
Terminal Value	67.7	Market RP	8.76%
Value of Equity	181.4	Cost of Equity	10.7%
Number of Shares (m)	914.8	Cost of Debt	3.20%
Value per share (S\$)	0.200	LT Growth	2.0%

Source: SIAS Research

Figure 5: Peer Comparison Set

	T12 PER	Current P/BV	T12 ROE	T12 ROA	Current Debt/Equity
Arrow Electronics Inc	10.0	1.1	9.8%	3.7%	45.8%
Avnet Inc	8.6	1.4	14.2%	5.8%	42.5%
WPG Holdings Co Ltd	13.2	3.0	24.7%	21.6%	142.8%
Yosun Industrial Corp	12.5	2.8	24.2%	9.5%	127.4%
Zenitron Corporation	11.5	1.0	9.3%	3.3%	99.3%
Supreme Electronics Co.,	9.3	1.2	14.1%	7.8%	68.3%
Weikeng Industrial Co.,	10.7	1.7	16.6%	7.2%	75.0%
Excelpoint Technology Ltd	28.1	0.8	3.1%	1.1%	60.9%
Average	13.0	1.6	14.5%	7.5%	82.8%
Serial System Ltd	9.4	1.2	14.0%	6.1%	74.8%

T12 PER for Serial is estimated from available 3Q FY10 data, while that T12 ROE and ROA is based on 1H FY10 information. For peers, ratios presented are based latest available information from Bloomberg.

Source: Bloomberg, SIAS Research

Figure 6: Financial Forecasts and Estimates

S\$ m	FY07	FY08	FY09	FY10F	FY11F	FY12F
Revenue	476.2	510.6	556.5	751.6	934.9	1075.1
Gross Profit	41.5	46.7	48.6	72.4	90.1	103.6
Operating Profit	9.4	8.5	9.0	22.9	29.4	33.9
Net Profit	7.3	6.0	7.5	14.7	19.6	22.6
Attributable to Shareholders						
Total Current Assets	148.5	114.2	161.0	214.9	295.6	307.2
Total Non-Current Assets	32.9	33.0	39.5	51.3	49.7	48.1
Total Current Liabilities	90.7	63.7	99.4	138.5	192.3	191.0
Total Non-Current Liabilities	10.7	2.5	7.5	13.6	13.6	13.6
Total Equity	80.0	81.0	93.5	114.1	139.3	150.6
Cash from Operating Activities	3.5	17.7	(3.7)	(4.7)	(27.2)	34.7
Cash from Investing Activities	18.5	(3.4)	(10.0)	(11.8)	(1.9)	(2.0)
Cash from Financing Activities	(14.1)	(12.4)	18.5	24.6	15.3	3.7
Net change in cash	7.9	1.9	4.8	8.1	(13.9)	36.5
Inventory Days	53	42	40	50	50	50
Receivable Days	48	44	41	45	45	45
Payable Days	48	38	33	40	40	40
Return on Common Equity (%)	9.1	7.6	8.7	14.4	15.8	15.8
ROA (%)	4.1	4.0	4.5	9.0	9.2	9.2
Debt/Equity (%)	47.3	38.2	50.4	69.8	64.2	69.4
Current Ratio	1.6	1.8	1.6	1.6	1.5	1.6
EPS (S cents)	1.9	1.0	1.1	1.9	2.3	2.5
BV/Share (S cents)	21.0	13.4	12.9	13.8	15.2	16.5
PER	8.2	16.0	14.4	8.5	7.1	6.5
P/BV	0.76	1.19	1.24	1.16	1.05	0.97

^FY10F EPS and BV/Share are based on the fully diluted share capital of 825m shares. FY11F and FY12F values are derived from an estimated enlarged share capital of 915m shares, assuming that the TDR listing is successful.

Source: Company Announcements, SIAS Research

Rating Definition:

Increase Exposure – The current price of the stock is significantly lower than the underlying fundamental value. Readers can consider increasing their exposure in their portfolio to a higher level.

Invest – The current price of the stock is sufficiently lower than the underlying fundamental value of the firm. Readers can consider adding this stock to their portfolio.

Fairly Valued – The current price of the stock is reflective of the underlying fundamental value of the firm. Readers may not need to take actions at current price.

Take Profit – The current price of the stock is sufficiently higher than the underlying fundamental value of the firm. Readers can consider rebalancing their portfolio to take advantage of the profits.

Reduce Exposure - The current price of the stock is significantly higher than the underlying fundamental value of the firm. Readers can consider reducing their holdings in their portfolio.

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