Sarine Technologies

Industrials

22 November 2017

Price	S$0.94
Market cap	S$331m
	US$/S$1.36

Preparing for the peak season

Sarine's ytd (Jan to Sep) profitability was relatively subdued, with lower equipment sales due to excess midstream inventories in Q2 and Q3, as well as the illicit actions of competitors. Simultaneously, Sarine incurred considerable R&D costs related to the development of Clarity and Colour grading technology and Sarine Profile. This was further exacerbated by the strengthening of the Israeli shekel. However, downstream demand remains strong (according to the company), while new products and lower R&D expenses should support earnings going forward. Sarine trades on a P/E of 16.3x FY17e, a 35% discount to the peer group.

Unexpected continuation of midstream weakness

Sarine reported a net loss of US$0.5m in Q317 (compared with a US$4.0m profit in Q316), affected by low capital equipment sales. This was the result of persistently high surplus inventories of polished diamonds in the midstream (Sarine's core end-market). The company's performance was further impaired by the illicit activities of its competition, as the process related to the legal actions initiated by Sarine is still in progress. Consequently, group sales declined by 34.6% y-o-y and 37.8% sequentially (compared to a historical Q3 vs Q2 drop in the range of 20-40%).

Management remains positive about retail demand

The company believes that the abnormal inventory build-up is not an indication of weakness in Sarine's key downstream markets and expects an inventory reduction as the peak season starts in Q417 and continues through Q118. The US retail diamond market displays constant solid performance, while China's market continues the recovery that began several months back. Furthermore, Sarine's new products are gradually ramping up, with Clarity and Colour grading technology launched in mid-September and expected to start contributing to group sales in Q118. The company also sees strong interest across Asia and North America for its retail sales support product, Sarine Profile.

Valuation: Deep discount amid high expectations

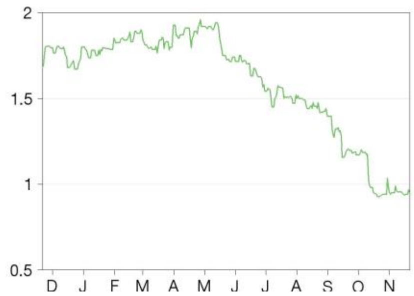
Sarine's shares currently trade at a P/E of 16.3x 2017e, representing a 35% discount to selected peers operating in the laboratory and site-based materials analysis and testing business. This is based on an average EPS forecast from two brokers at 4.25 US cents (one of which has not yet fully captured Q3 results).

Consensus estimates

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	67.1	4.3
12/16	72.5	22.0	5.14	4.50	13.4	6.5
12/17e	73.6	17.9	4.25	3.55	16.3	5.1
12/18e	84.3	29.3	6.95	3.85	9.9	5.6

Source: Sarine Technologies accounts, Bloomberg adjusted consensus as at 16 November 2017.

Share price performance



Share details

Code	SARINE.SP
Listing	SGX
Shares in issue	350.8m

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$27.8m).

Bear

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

Analysts

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Sarine Technologies coverage is provided through the SGX research scheme

Financials: Q317 results review

Sarine reported weak Q317 numbers, with group revenues declining by 34.6% y-o-y to US$11.3m on the back of lower capital equipment sales. This was caused by the continued build-up of surplus inventories of polished diamonds in the midstream, which the company had not expected to continue into Q3.

It is important to note that Q3 is a low season for Sarine and sales are usually 20-40% lower sequentially, given that a great deal of annual polished diamond sales volumes occurs from late October/early November to February. For instance, in the US, sales during the 2.5 months of holiday season towards the year-end constitute more than 50% of full year sales. The time between buying rough diamonds and the moment when polished diamonds can be offered to the wholesale players is typically three to six months (depending on size), creating a delayed response from manufacturers to a slowdown in demand. This in turn results in temporary oversupply around late Q2/early Q3, which puts downward pressure on the price of polished diamonds.

Having said that, the extent of inventory build-up in Q317 seems to be above average, with sales declining sequentially by 37.8% (ie at the higher end of the normal range indicated by Sarine). Importantly, this comes after a 5% y-o-y sales decline in H117 to US$34.4m. Also, Q317 sales constitute only 25% of ytd revenues, compared with a five-year historical average of 28%. Current sentiment among Indian diamond manufacturers (which represent c 70-80% of Sarine group sales) remains weak, with some of the players reducing the number of production staff. Nevertheless, despite the difficulties midstream players are currently facing, management estimates that counterparty credit risk is low.

According to the management, three-quarters of the sequential decline (ie around 30pp) was due to weak market conditions. The balance was related to the ongoing illicit activities of Sarine's competitors (in particular with respect to inclusion mapping systems) and this will continue to affect the company's performance in Q4 as the countermeasures already initiated are yet to fully bear fruit. The company remains active in the pursuit of legal action but also believes that several features of the newest Advisor 7.0 version should incentivise brand loyalty (c 60% of key customers have already migrated from previous versions). Furthermore, Sarine is about to launch a new system (Meteorite), which is aimed at being the most cost-effective system in the market for scanning very small, rough diamonds and allowing Sarine to compete with the illicit competition in its main market.

On the positive side, recurring revenues related to Galaxy products, Quazer services, polished diamond-related services, annual maintenance costs, etc remained stable and contributed more than 46% to group revenue (9M16: 40%). Importantly, the number of stones processed by the installed base did not drop significantly, according to the company. Recurring revenues should continue to grow, driven by Galaxy and Sarine Profile products. However, as Sarine becomes more active in the smaller diamond sizes, the sales growth rate for Galaxy family systems will become more moderate compared to the historical average.

Sarine's gross margin in Q317 declined slightly to 65.7% from 68.6% in Q316, with the 28.7% y-o-y decline in COGS being mostly volume-driven. The company booked a minor US$11,000 operating loss for the quarter (Q316: profit of US$4.5m), with overall operating expenses down just 11% in Q317 due to an increase in G&A costs (US$1.60m vs US$1.15m in Q316), largely on the back of IP litigation. According to management, the run rate for litigation costs in absolute terms should be maintained at a similar level until the end of the year. The bottom line was also negatively affected by currency headwinds, amid a c 10% depreciation of the Israeli shekel vs the US dollar, with most of Sarine's R&D and personnel expenses denominated in the former.

Conversely, R&D costs dropped 14.3% y-o-y and 20.5% sequentially to US$2.4m, as the bulk of expenses associated with the Clarity and Colour grading technology, as well as Advisor 7.0 planning software, has already been incurred (although the company capitalised US$0.4m of costs associated with the former project in Q317). This is in line with management's statement that R&D expenses reached a peak in H117, which should make it easier for Sarine to improve the bottom line next year.

Sarine's balance sheet remains firm, with US$27.8m in net cash as at end-September 2017, and the decline versus end-2016 (US$38.0m) being mostly attributable to the 2016 final and 2017 interim dividend payments (US$15.8m in total), US$0.5m spent on share buyback and expenditures related to new facilities in Surat India.

Exhibit 1: Results highlights

US$000s	Q317	Q316	Y-o-y (%)
Revenues	**11,285**	**17,250**	**(34.6)**
Cost of sales	(3,870)	(5,424)	(28.7)
Gross profit	**7,415**	**11,826**	**(37.3)**
gross margin	*65.7%*	*68.6%*	*-285bp*
Research and development costs	(2,430)	(2,834)	(14.3)
Sales and marketing expenses	(3,393)	(3,341)	1.6%
General and administrative expenses	(1,603)	(1,149)	39.5%
Operating profit	**(11)**	**4,502**	**N/M**
Net finance income (expense)	53	403	(86.8)
Income taxes	(572)	(918)	(37.7)
Post tax profit	**(530)**	**3,987**	**N/M**
Net margin	*N/M*	*23.1%*	*N/M*
weighted average number of shares ('000s)	350,939	349,984	0.3%
EPS (US$ cents)	**(0.15)**	**1.14**	**N/M**

Source: Sarine Technologies accounts

Demand outlook remains robust ahead of the peak season

Sarine remains confident with respect to the end-market outlook for the upcoming high season and does not see any weakness in consumer demand (with the exception of the domestic market in India). The US market is performing consistently well and has already entered the holiday season covering Thanksgiving, Christmas and New Year. China (the second most important market for Sarine) exhibits strong consumer demand for luxury goods and diamond jewellery in particular. This represents a continuation of recovery seen over the last six months after more than two years of subdued activity in this country.

New products gradually gaining momentum

In line with earlier guidance, Sarine's Clarity and Colour grading technology was formally launched in mid-September at a Hong Kong trade show. Management expects the initiation of grading reports and first revenue contribution in Q118. According to the company, this technology addresses a US$500m market with 7m diamond grading reports generated annually for stones from a quarter of a carat (or even from a fifth of a carat) and price per carat reaching US$50-100. Sarine expects that its proprietary technology will allow it to grade polished diamonds from a tenth of a carat and up, bringing the potential market size to US$750m.

The company's polished diamond retail-sales supporting offerings, Sarine Profile (which was launched in 2015), seems to be gaining some traction also, with solid interest across Asia, including Japan (there is already a good customer base here, K-Uno recently added) and Australia, as well as South Korea (eg Golden Dew), Singapore (eg Soo Kee Group) and Thailand (Aurora). The company sees good momentum in North America, with increased interest from large regional and national chains and high-end independents in the US. Sarine highlighted that it remains on track to increase the number of stones scanned using Sarine Profile in 2017 vs 2016. However, the platform still represents a rather minor part of the business (around 2% of group sales in 9M17). The critical mass required to see new customers coming on their own is yet to come, although in Singapore the company has already experienced some spontaneous attraction of new clients.

Valuation

Sarine trades on a trailing 12-month P/E of 23.8x. Based on adjusted Bloomberg consensus for 2017 and 2018, the shares are trading at a P/E of 16.3x and 9.9x respectively, with expected y-o-y EPS growth of -17% and 64%, respectively. We note that the market consensus includes only two broker estimates, with one not yet adjusted post 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 could 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. Sarine is trading at a wide discount to this peer group on both FY17e P/E and EV/EBITDA ratios (35% and 27%, respectively). The discount widens in 2018, based on the strong growth expectations implied by Bloomberg consensus.

In the peer comparison table (Exhibit 2) we also show two Indian companies, primarily engaged in midstream manufacturing. 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 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	2017e	2018e	2017e	2018e	2017e
Bruker Corporation	US$5,115	37.3	26.8	24.0	16.1	14.9	0.5%
Bureau Veritas SA	€10,048	33.2	25.0	23.2	14.3	13.8	2.4%
Spectris ADR	£3,086	N/M	19.4	17.2	13.6	12.1	2.1%
Intertek Group	£8,669	30.9	28.2	26.3	16.9	15.9	1.3%
Peer group average	**-**	**33.8**	**24.9**	**22.7**	**15.2**	**14.2**	**1.6%**
Sarine Technologies	SG$330	23.8	16.3	9.9	11.2	6.0	3.8%
Premium/(discount)	-	**(30%)**	**(35%)**	**(56%)**	**(27%)**	**(57%)**	**(58%)**
Gitanjali Gems	INR8,220	4.7	N/A	N/A	N/A	N/A	N/A
Asian Star	INR18,174	27.8	27.6	23.9	N/A	15.6	N/A
Chow Tai Fook	HK$82,300	27.3	26.9	21.0	N/A	13.0	N/A
Tiffany & Co	US$11,611	23.9	24.7	23.4	N/A	11.8	N/A
Peer group average	**-**	**20.9**	**26.4**	**22.8**	**N/A**	**13.5**	**N/A**

Source: Company accounts, Bloomberg consensus as at 16 November 2017

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