

Serial System Ltd

Back in Focus

Serial System Ltd (Serial) will be releasing its results within the next four weeks and we expect the company to continue posting positive growth in 2Q FY11F. If true, shareholders can look forward to higher interim dividends from the company. Serial's latest application for a TDR listing has been approved by the Taiwan Stock Exchange, giving rise to a potential re-rating of its share price in the months to come. **Maintain Increase Exposure based on an intrinsic value of S\$0.200.**

Key Developments:

Positive Results to Look Forward To: Serial is anticipated benefit from sustained demand for semiconductors in 2Q FY11F and post an overall stronger 1H 2011 versus 1H 2010. 2Q profitability will also be supported by the acquisition of the profitable Contract Sterilization Services Pte Ltd.

TDR Listing is Back: We are relieved that Serial finally obtained approval from the Taiwan Stock Exchange to issue and list TDRs. While the listing is yet to be confirmed, we are optimistic that Serial will be successful in this latest attempt. Not only are Serial's peers listed in Taiwan trading at higher multiples, the book building and IR activities at a later stage may generate positive share price movement – although fundamental value remains unaffected. Funds raised will strengthen Serial's capital base and allow the company to extend more competitive credit terms to customers (especially the larger ones).

Inorganic Growth Provides Additional Kicker: Serial is also acquiring Intraco Technology Pte Ltd, which is a fellow distributor of semiconductors, for its product lines and revenue base of >S\$50m/year or approximately 7% of Serial's annual sales. This transaction gives us comfort over Serial's growth going into 2H 2011 and in 2012. While Intraco Technology Pte Ltd is currently loss making, we foresee that the Serial can reduce any resultant redundancies from the acquisition and integrate Intraco's operations into its own to raise profitability possibly within 2011 itself.

Increase Exposure

- Intrinsic Value S\$0.200
- Prev Close S\$0.146

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	FY09	FY10	FY11F
Revenue	556.5	746.2	828.9
Gross Profit	48.6	69.4	76.9
Earnings	7.5	16.2	18.4
EPS (S cts)	1.1	2.2	2.1

Source: Company, SIAS Research

Key ratios (FY11F)

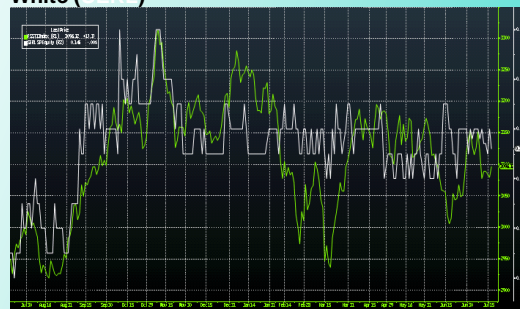
PER	6.9
P/BV	1.0
Return on Common Equity	15.3%
Gross Debt to Common Equity	9.0%
Current ratio	1.5

Source: SIAS Research

Indexed Price Chart

Green (FSSTI)

White (SERL)



Source: Bloomberg

52wks High-Low	S\$0.185 /S\$0.120
Number of Shares	821.2m
Market Capitalization	S\$119.9m

Analyst:

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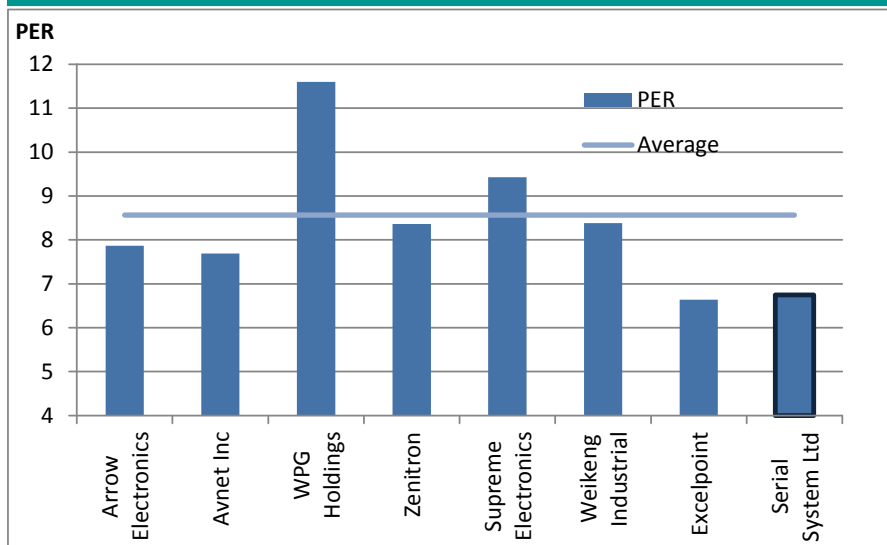
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TDR Listing Revived

TDR Listing Revived: Serial re-submitted its TDR listing application on 28 Jun 2011 and obtained approval from the Taiwan Central Bank and the Taiwan Stock Exchange on 15 Jul 2011. Serial now needs the approval of the Securities and Futures Bureau of Taiwan before it can proceed with the book building exercise for its Taiwan Depository Receipts (TDRs). We find these developments encouraging. If all approvals are obtained, we expect Serial to list its TDRs within the next six months.

So What? We continue to view the TDR listing as a viable catalyst for the re-rating of Serial's share price as its peers listed overseas trade at an average trailing PER of 8.57x versus 6.75x for the company. If Serial trades at 8.57x trailing PER, we are looking at a potential price of S\$0.185, representing a 27.6% upside for Serial based on the close of S\$0.145 on 15 Jul 2011. Nonetheless, this gap in valuation is a moving target. The basis for Serial's value should be its future performance, which is expected to be promising.

Figure 1: Peer Trailing PER Comparison (as of 15 Jul 11)



Source: Bloomberg, SIAS Research

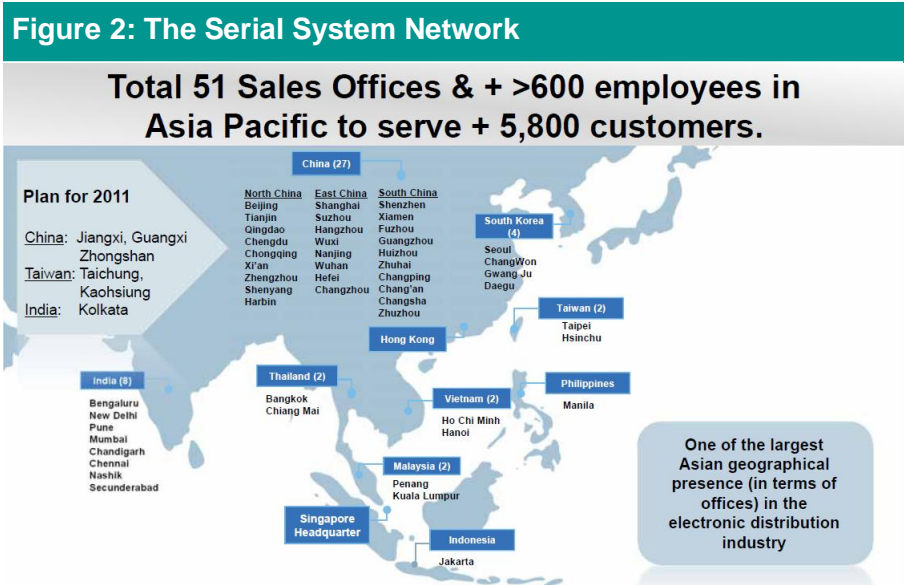
Serial is seeking to list the equivalent of 90m new shares in the company (11.0% of its existing share capital and 9.9% of the enlarged share capital). Based on Serial's close of S\$0.146 on 19 Jul 2011, it can raise about S\$13.1m from the issue of TDRs. Our previous discussion with the management some time back had suggested that Serial is looking at a higher listing price for its TDRs. If a higher issue price is obtained, net proceeds raised will be higher.

How the Funds will be Used: The funds raised will strengthen Serial's equity base and potentially give it more flexibility in securing borrowings and extending credit to customers, especially in the more competitive China, Hong Kong and Taiwan markets. In these markets, larger competitors have the financial muscle to extend more lucrative credit terms to customers and Serial risks losing out without a stronger capital base.

Any remaining funds can then be utilized for business expansion and acquisitions. Firstly, Serial has been expanding its network with plans to open more sales offices in China, Taiwan and India. Particularly, in Taiwan, the TDR listing will also create a local banking relationship for Serial to tap on for loans, putting the company on a more level playing field against local incumbents.

Secondly, Serial has been in acquisition/investment mode in 2011 – starting with a medical devices company, an IT products distributor (JEL Corporation) and more recently, a fellow components distributor (Intraco Technology Pte Ltd). Thus far, Serial's acquisitions have shown that the company typically invests in targets that offer complementary benefits to Serial's business e.g. new geographical markets, customers or product lines not carried by Serial.

Nonetheless, the proposed investment in JEL Corporation was not successful as JEL could not extend the deadline for it to be removed from SGX's watchlist. Serial had originally intended to acquire JEL's distribution network in Asia and Middle East. Right now, Serial's focus seems to be on the "Intraco Technology" acquisition, which we will elaborate more later.



Source: Company Corporate Presentation as of Apr 2011

Expect to See Growth in 1H Results

Top-line Growth Should Remain Robust: According to the Semiconductor Industry Association, global semiconductor sales grew by 7.5% YoY in the first five months of 2011. We are optimistic of 1H sales at Serial, which reported 4.1% YoY growth for 1Q 2011. Our view is that growth would have been higher if not for the rapid appreciation of the SGD against the USD. Serial purchases and sells some of its goods in USD.

CSS to Support Bottom-Line Growth: Serial's profitability will also be boosted by the acquisition of Contract Sterilization Services Pte Ltd (CSS) in the beginning of Mar 2011. CSS produces medical devices such as heart-lung packs used in bypass operations. Serial acquired CSS as the medical devices industry offered more lucrative margins than the components distributorship business. Accordingly, CSS is a profitable entity. It made S\$1.0m in profit before tax in its last financial year and as such is unlikely to be a drag on Serial's bottom-line. However, its impact on Serial will be limited by its much smaller size. The crux lies with how Serial grows this business going forward.

Any impact from the Tohoku earthquake? Although one of Serial's suppliers Texas Instruments has operations in Japan, Serial is mitigated from the impact of the earthquake by a) its large multi-industry pool of customers and b) a rich collection of suppliers. These mitigating factors should bode well for the company.

Bottom-line: We expect Serial to make S\$7.1m PATMI in 1H FY11, based on the assumptions of a) 10% YoY sales growth in 2Q FY11F and b) similar margins as 2Q FY10 in 2Q FY11F. If our forecasts are realized, shareholders may enjoy higher dividends based on a constant payout ratio of about 40%.

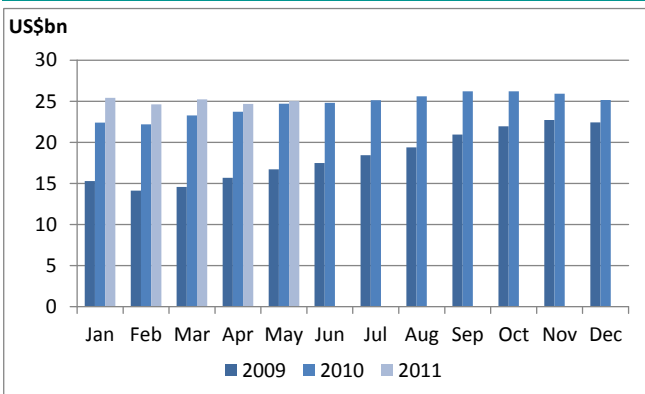
Figure 3: Recent Results Overview and Forecasts

S\$m	1Q FY10	2Q FY10	1H FY10	2H FY10	FY10
Revenue	182.3	188.7	371.0	375.2	746.2
Gross Profit	16.6	19.1	35.7	33.7	69.4
PATMI	2.9	3.6	6.5	9.7	16.2
Gross Margin	9.1%	10.1%	9.6%	9.0%	9.3%
Net Margin	1.6%	1.9%	1.7%	2.6%	2.2%
Dividends (cents per share)			0.28	0.67	0.95

S\$m	1Q FY11	2Q FY11F	1H FY11F	2H FY11F	FY11F
Revenue	189.8	207.6	397.4	431.5	828.9
Gross Profit	17.1	21.0	38.1	38.8	76.9
PATMI	3.2	3.9	7.1	11.2	18.4
Gross Margin	9.0%	10.1%	9.6%	9.0%	9.3%
Net Margin	1.7%	1.9%	1.8%	2.6%	2.2%
Dividends Forecast (cents per share)			0.35	0.55	0.89

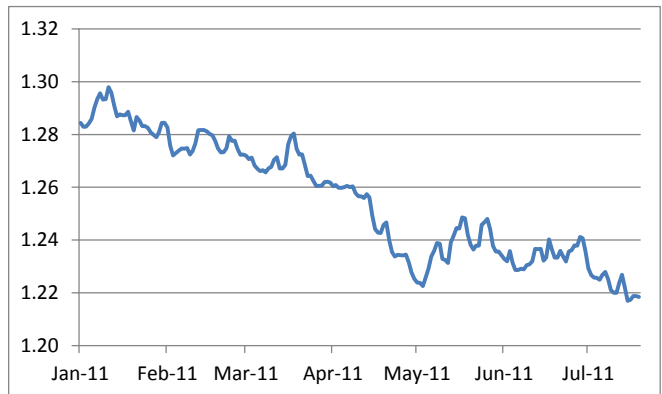
Source: Company, SIAS Research

Figure 4: Global Semiconductor Sales



Source: Semiconductor Industry Association, SIAS Research

Figure 5: USD/SGD Exchange Rate



Source: Bloomberg, SIAS Research

Global semiconductor sales are typically stronger in 2H versus 1H of each year. Hence, we can continue to look forward to sequential growth in 2H. Our forecasts imply that 2H FY11F revenue will grow by 8.5% over 1H FY11F sales.

Why Acquire Intraco Technology Pte Ltd

An Industry Peer: Intraco Technology Pte Ltd (Intraco Tech) is a 100% owned subsidiary of SGX listed Intraco Limited. Its key activities are in the distribution of computer components and semiconductors, as well as the provision of wireless/network solutions for end users.

Intraco Tech's parent company Intraco Limited earned the bulk of its revenue (about 65%) from the trading of industrial materials, agricultural and food products. As such, this disposal will allow Intraco Limited to focus its resources on its key profit driver.

What's in it for Serial?

Access to New Suppliers: A careful reading of Serial's announcement on the acquisition will reveal that the deal is conditional upon certain suppliers of Intraco Tech agreeing to maintain their relationship with the latter after the transaction.

As such, Serial seems to be acquiring Intraco Tech for its "product line cards" – each of which represents a particular brand of products – that the company does not already have. Given Serial's portfolio of >5,800 customers in the Asia Pacific region, there is scope for Serial to raise the revenue potential of these new products in approved territories.

Inorganic Growth: Intraco Limited's 2010 Annual Report showed that it earned revenue of S\$53.1m from the "Semiconductors" segment, which has the same key activities as Intraco Tech. This is equivalent to 7.1% of Serial's FY10 revenue. As such, this acquisition will add to top-line growth in the latter part of 2011 and in 2012, giving us higher confidence in Serial's growth.

Is the Transaction Worthwhile? The consideration for the equity interest in Intraco Tech is US\$100k and the repayment of Intraco Tech's shareholder loans of US\$3.4m and S\$3.6m. This works out to a total of about S\$8.0m – of which about S\$7m will be paid out semi-annually over the next two years. Therefore, Serial is paying about 15 S cents for each dollar of revenue from Intraco Tech. Conversely, Serial is currently trading at 0.32x price to FY10 sales per share.

An issue lies with the profitability of Intraco Tech. It lost US\$0.5m in 1Q 2011 and US\$1.4m in 2010. We envisage that Serial can a) amalgamate (and streamline) Intraco Tech's operations into its own, thereby creating cost savings and b) push Intraco Tech's products through its larger network of customers, thereby raising sales for the group. If the integration of both companies is well executed, we do not foresee these losses to last.

Forecasts and Valuation

We value Serial at S\$0.200 per share based on forecast revenue of S\$828.9m and EBIT of S\$27.2m for FY11F. We assume that Serial will be able to grow its revenue by 15% annually over FY12F and FY13F. This is a relatively conservative expectation given that Serial has managed to grow its top-line at a CAGR of 29% since 2001. We expect Serial to maintain its margins in subsequent years and achieve PATMI of S\$24.3m by FY13F, translating to a CAGR of 14.6% over the next three years.

Our model takes into the account the effects of dilution from the issue of new shares for the TDR listing. As such, the final value of the firm includes estimated net proceeds of S\$13.1m from the TDR issue, which is based on Serial's previous closing price of S\$0.146 x 90m new shares. The number of shares used in our model also includes the new shares to be issued.

Figure 6: Economic Profit Valuation Model

S\$ m	FY11F	FY12F	FY13F
Revenue	828.9	953.2	1096.2
EBIT	27.2	31.3	35.9
Tax on EBIT	-8.2	-9.4	-10.8
NOPLAT	19.1	21.9	25.1
Invested Capital	190.6	220.4	233.1
% of Debt	41.8%	39.1%	37.0%
% of Equity	58.2%	60.9%	63.0%
WACC (%)	7.6%	7.8%	8.0%
Capital Charge	14.5	17.2	18.7
Economic Profit	4.6	4.7	6.5
Terminal Value			71.2
Discount Rate	1.0	0.9	0.8
Present Value	4.4	4.2	5.3
Book Value	108.2	Risk Free Rate	2.1%
Explicit Value	13.9	Beta	1.1
Terminal Value	58.8	Market RP	8.7%
Value of Equity	181.0	Cost of Equity	11.3%
Add est. proceeds*	13.1	Cost of Debt	3.50%
Final Value of Equity	194.1	LT Growth	2.0%
Number of Shares (m)	911.1		
Value per share (S\$)	0.200		

*S\$0.146 x 90m shares (from TDR listing)

Source: SIAS Research

Figure 7: Financial Forecasts and Estimates

S\$m	FY08	FY09	FY10	FY11F	FY12F	FY13F
Revenue	510.6	556.5	746.2	828.9	953.2	1096.2
Gross Profit	46.7	48.6	69.4	76.9	88.5	101.7
Operating Profit	8.5	9.0	24.3	26.9	31.0	35.6
Net Profit	6.0	7.5	16.2	18.4	21.2	24.3
Attributable to Shareholders						
Total Current Assets	114.2	161.0	223.7	248.8	284.4	322.9
Total Non-Current Assets	33.0	39.5	54.6	57.9	61.1	64.4
Total Current Liabilities	63.7	99.4	155.4	160.5	186.6	213.9
Total Non-Current Liabilities	2.5	7.5	12.0	12.0	12.0	12.0
Total Equity + MI	81.0	93.5	110.9	134.2	146.9	161.5
Cash from Operating Activities	17.7	-3.7	-10.2	-11.7	21.2	-11.3
Cash from Investing Activities	-3.4	-10.0	-16.9	-6.8	-6.8	-6.9
Cash from Financing Activities	-12.4	18.5	39.3	8.5	-12.7	10.4
Net change in cash	1.9	4.8	12.2	-10.0	1.7	-7.8
Inventory Days	42	40	44	45	45	45
Receivable Days	44	41	41	50	50	50
Payable Days	38	33	38	40	40	40
Return on Common Equity (%)	7.6	8.7	16.2	15.3	15.3	16.0
ROA (%)	4.0	4.5	9.6	9.0	9.3	9.5
Gross Debt/Equity (%)	38.2	50.4	73.6	65.3	59.6	69.8
Current Ratio	1.8	1.6	1.4	1.6	1.5	1.5
EPS (\$ cents)	1.0	1.1	2.2	2.1	2.3	2.7
BV/Share (\$ cents)	13.4	12.9	13.5	14.7	16.1	17.7
PER	14.6	13.2	6.6	6.9	6.3	5.5
P/BV	1.09	1.13	1.08	1.00	0.91	0.83

Our forecasts assume the successful listing of 90m new shares as TDRs in FY11F at a price of S\$0.146.

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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