

## Serial System Ltd

### Going for serial successes?

Serial System Ltd's (Serial) prospects look bright with major semiconductors and electronics companies raising their revenue forecasts. Serial is poised to ride on the expansion of these companies especially after it secured two new major distributorships last year – Texas Instruments in Taiwan and Tyco Electronics in Hong Kong, China and Taiwan.

Serial's main edge is its large customer base and distribution network in China. While the major distributors such as WPG Holdings continue to target the top tier customers, Serial's hold over the 2nd and 3rd tier manufacturers offer value to its suppliers who want to ensure deep distribution of their products within China and yet will prefer to deal with orders of significant volume.

China is expected to continue growing at its breakneck pace going forward. Growth estimates range from the government's target of 8% to more than 10% in 2010. As such, demand for electronic components and semiconductors will continue to be strong. Many major brands will want to build market share in China. This is where Serial comes in with its established network of manufacturers on the ground.

We believe that the key risk behind Serial is its lack of size and hence, limited economies of scale. Therefore, the slightest change in margins can materially affect the bottom line. However, Serial has been paying out close to 50% of its profits as dividends each year. As such, loyal investors can participate in a significant share of profits in good years. We have conservatively valued Serial at 10x FY10F EPS. Nonetheless, Serial should trade at multiples closer to its peers as its revenue base approaches them over time. Invest with an intrinsic value of S\$0.140.

## Invest

- Intrinsic Value S\$0.140
- Prev Closing S\$0.100

### Main Activities

Serial System Ltd is principally engaged in the semiconductors and components distribution business. Its geographical segments include Singapore, PRC, Hong Kong, Korea, Taiwan, Malaysia and Thailand.

### Financial Highlights

(Y/E Feb) S\$'mn	FY08	FY09	FY10F
Revenue	510.6	556.5	640.0
Operating Profit	8.5	9.0	13.0
Net Profit	6.0	7.5	10.8
EPS (S cts)	1.0	1.1	1.4

FY09E: Numbers are based on SIAS Research Estimate after consolidation

Source: SIAS Research Estimate

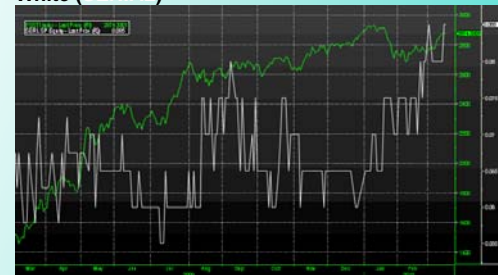
### Key ratios (FY10F)

PER	7.1
P/BV	0.8
ROE	5.4%
Net gearing	10.9%
Current ratio	1.8

Source: SIAS Research Estimate

### Indexed Price Chart

Green (FSSTI)  
White (SERIAL)



Source: Bloomberg

52wks High-Low	S\$0.110/S\$0.050
Number of Shares	724.12m
Market Capitalization	S\$72.4m

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## Going strong in North Asia

Serial System Ltd (Serial) is a major semiconductor and electronics components distributor in the Asia Pacific region with revenue of S\$557m in FY009. In a nutshell, it sources goods from an impressive lineup of more than 56 global suppliers such as Texas Instruments, Analog Devices and Avago Technologies, and resells them to a broad network of 4,500 customers, such as contract manufacturers in various industries such as consumer appliances, automotive, medical devices. Its regional footprint is represented by 40 offices in 10 countries, including 23 cities in China, supported by 7 product distribution centers.

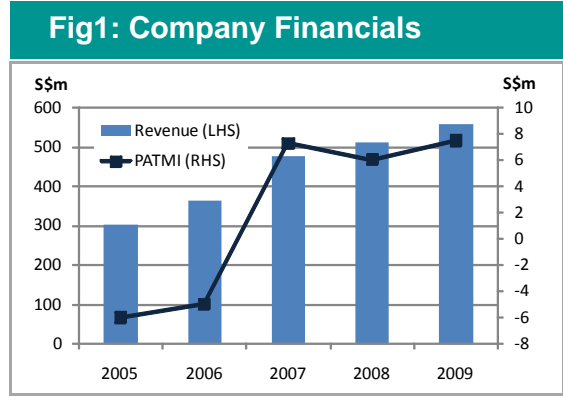
Key recent events that have caught our attention include:

- Award of Tyco Electronics' distribution rights for China, Hong Kong and South Korea in October 2009 along with Yosun Industrial Corp. Serial's strategic intent is to build Tyco Electronics' products into its largest non semiconductor line.
- Acquisition of the distribution business for Texas Instruments' products, associated customer base and product intellectual property for related products in Taiwan in May 2009.

Serial also offers design and technology solutions as well as material and inventory planning and management services for customers. In March 2010, Serial announced its entry into the outdoor media advertising business with its subsidiary, Serial Multivision Pte Ltd's appointment to manage Asia's largest commercial LED advertising screen on Grand Park Orchard.

We prefer to focus on Serial's recent moves to expand its distribution network as highlighted above because they symbolize how Serial intends to grow its business going forward. These actions are consistent with the current trend in the electronics industry to streamline its supply chain.

Essentially, upstream and downstream manufacturers want faster time-to-market with fewer suppliers in between. This translates into two major implications for Serial:



Source: Company



Source: Company, SIAS Research Estimate

**Suppliers** want distributors who have an established network on the ground to consolidate orders from smaller customers and provide significant order volume. We believe this is why Serial acquired the Texas Instruments distribution business in Taiwan. By combining the Taiwan and China markets, this effectively secures Serial as one of Texas Instruments' most important distributors in North Asia.

Texas Instruments recently raised the lower bound of its sales forecast for 1Q10, effectively moving the midpoint of their estimates up 2% to US\$3.13bn. We believe that Asia will be a significant growth driver to Texas Instruments, boding well for Serial.

**Customers** (manufacturers) will want to purchase from providers who carry a comprehensive product range so that they need only order from as few suppliers as possible, reducing waiting time for parts or cutting inventory costs incurred to maintain slack.

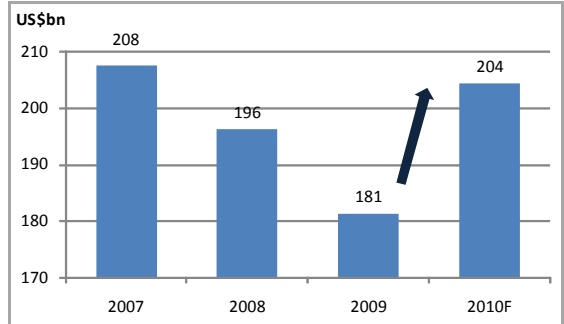
The semiconductor and electronics business can be summarized into two broad segments: passive and active components. Passive components typically refer to parts such as resistors, connectors and switches. Active components refer to integrated circuits and microchips which form the brain behind most equipment.

Tyco Electronics is a major passive components supplier in the market. Tyco Electronics expects revenue for 2Q10 to range from US\$2.85bn to US\$2.95bn, up 22 to 26% YoY. By adding Tyco Electronics to its product line in North Asia, Serial strengthens its ability to provide both active and passive components to the same customer, thus increasing revenue per customer.

Of note, Tyco's products are used in various industries such as automotive, communication systems, aerospace, marine and medical. This presents opportunities to Serial, which also has a similarly broad set of end user markets. Based on our understanding, Serial is starting from ground zero with Tyco Electronics in North Asia. As such, we can expect sale of Tyco Electronics' products to be a major revenue driver going forward.

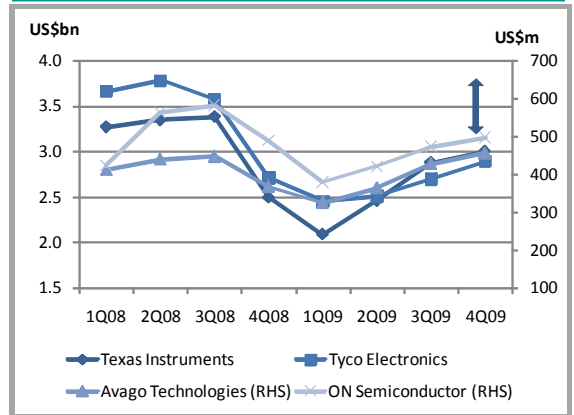
In addition, most suppliers continue to be heavily focused on the active components market which are of higher value, but lower margin. Hence, Serial's expansion in the passive components market can be viewed as a defensive move to maintain or raise gross margin.

**Fig3: Top 30 Semi Sales**



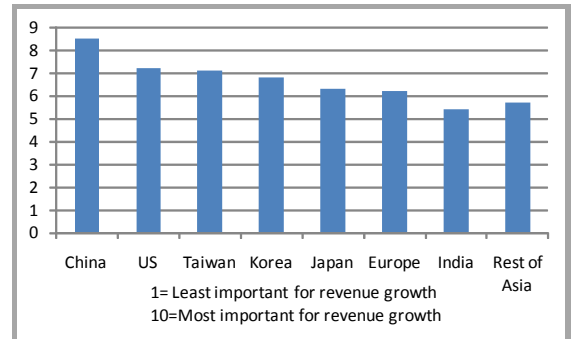
Source: Global Semiconductor Alliance

**Fig4: Selected Suppliers' Revenue**



Source: Bloomberg

**Fig5: Average Scores of Key Geographical Growth Markets by 2012, among Semiconductor Executives**



Source: KPMG

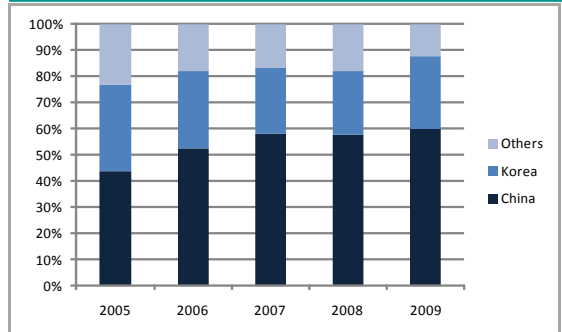
## China to keep consuming

Serial's focus on North Asia, particularly China, is not surprising. China is a major manufacturer and is going to be a major consumer to the world. Since 2005, production of motor vehicles grew at a CAGR of 25% to 13.8m units in 2009 and production of household refrigerators grew at a CAGR of 19% to 59.3m units in 2009. In 2010, recovering exports and consumption will continue to drive production growth. Our contact with a number of manufacturing companies in the course of our work also suggests an accompanying expansion in capacity to meet China's growing demand.

Consumption contributed 4.6 percentage points towards the 8.7% GDP growth of 2009. Come 2010, we expect consumption to continue its strong growth with more specific policies from the government to boost retail sales. Of note, the Chinese government intends to promote rural residents' purchase of home appliances and motor vehicles. In particular, a trial program to subsidize home appliances such as colour televisions and refrigerators was extended nationwide this year from 12 provinces previously. Some 359 manufacturing companies won bids to join the program. This bodes well for Serial which serves a large manufacturing base.

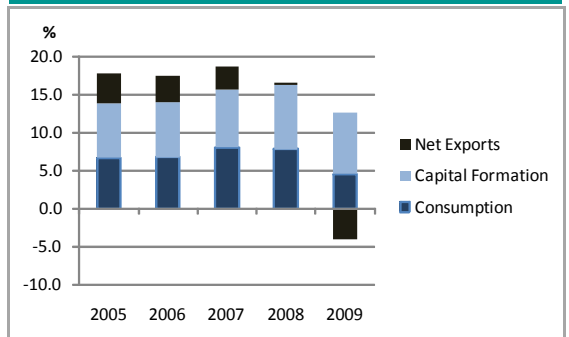
Increased production of automobiles will spur demand for electronics as vehicles today use more electronic components than before; China intends to continue subsidizing rural purchases of vehicles. According to the Global Semiconductor Alliance, automobiles currently use US\$320 worth of semiconductors per unit with 25 microcontrollers, more than double that of 1999 when the average value per unit was US\$150 on only 10 microcontrollers. Hence, demand for electronics is becoming increasingly robust with widespread use.

**Fig6: Revenue Mix By Region**



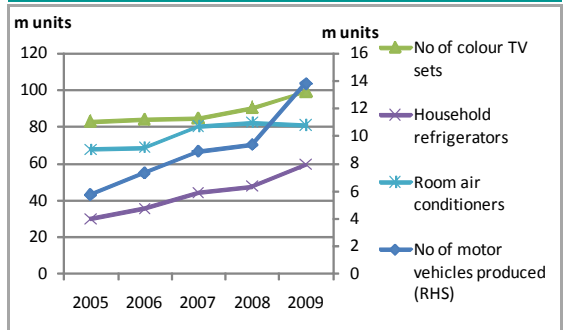
Source: Company

**Fig7: GDP Growth by Expenditure, China**



Source: National Bureau of Statistics of China

**Fig8: China Production of Automobiles and Major Home Appliances**



Source: National Bureau of Statistics of China

## Managing the competition

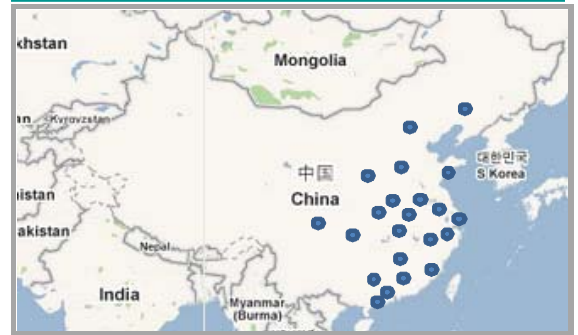
Tyco Electronics' selection of Serial, along with Yosun Industrial Corp, as a distributor in China, Hong Kong and Taiwan also shows that Serial's distribution network in North Asia, particularly China, is comparable to that of its peers despite its smaller revenue base. The disparity in size is largely because its competitors' volume is supported by the sale of computer chips such as Intel processors. Based on its product line card, which is absent of major computer chip companies such as Intel and AMD, we think that Serial has intentionally steered clear away from serving computer manufacturers to avoid head on competition.

Serial's major competitors include Arrow Electronics, Avnet Inc., WPG Holdings, Yosun Industrial Corp. Last week, WPG Holdings announced it would acquire Yosun Industrial Corp via a share swap. This creates an industry giant with annual revenue in excess of S\$13bn. We noted that Yosun Industrial Corp was also appointed a distributor of Tyco Electronics' products in North Asia. However, this does not necessarily mean more intensive competition for Serial; all is not lost.

With a large customer base vis-à-vis its supplier network, it becomes clear that Serial is targeting 2nd and 3rd tier manufacturers that top suppliers and distributors find too small to work with effectively. Based on our understanding, manufacturers must have monthly order volume of US\$20m to US\$30m before they can be considered as top tier customers. The consolidation of WPG Holdings and Yosun Industrial Corp combines their market presence, but also suggests that they are concentrating their efforts on serving top tier customers. This leaves Serial comfortably in its niche position targeting small and medium sized customers.

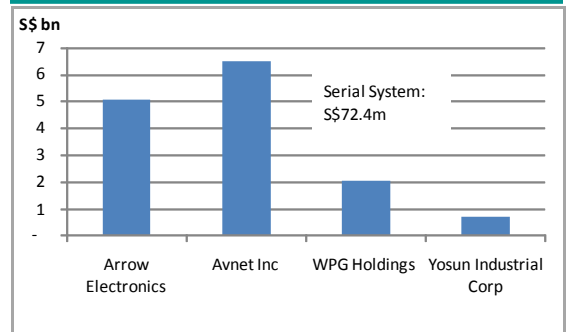
Smaller customers are not necessarily bad news. Serial has an extensive network in China covering more than 22 cities. By being close to their customers, Serial is able to provide timely and reliable service to their customers. While this may seem trivial, Serial's proximity to customers allows it to establish itself as a key supplier to smaller, but expanding manufacturers, thus latching onto their growth.

**Fig9: Serial's China Network (Blue Dots)**



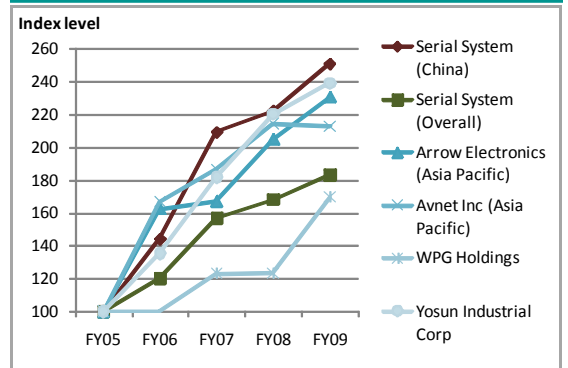
Source: Company, Google Maps

**Fig10: Peer Comparison by Market Capitalization**



Source: Bloomberg

**Fig11: Revenue Levels, against Peers (FY05=100)**



Source: Company, SIAS Research Estimate

## Lack of scale: a key concern

Thus far, we have elaborated on Serial's strategy to entrench its market position and support margins. However, we think that this does not absolutely absolve Serial from its key source of uncertainty – lack of scale. As a result, Serial does not enjoy the economies of scale to offset the low profit margin typical of the distribution industry.

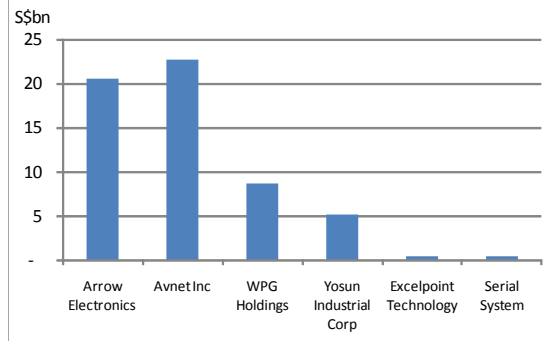
We noted that Serial's gross and net margins are quite respectable compared to its peers. Gross margin at 8.7% is higher than that of its Taiwanese counterparts. However, its net margin averaging at 1.35% since FY07 is still dangerously thin. Based on FY09 financial information, a 1% change in cost of sales will translate into a 56% change in profit after tax. Hence, Serial does not enjoy a thick profit buffer against unforeseeable circumstances such as the loss of major distributorships or customers.

In line with its strategies to grow its revenue base, we forecast a 15% YoY growth in revenue to S\$640m by FY10F and incorporate a 0.2 percentage point increase in gross margin to account for the expansion of the higher margin passive components product line. Essentially, we project a PATMI of S\$10.8m for FY10F and S\$11.2m for FY11F, representing strong earnings growth of 44% and 21% respectively.

However, FY10F EPS will come in at 1.42 cents up only 28% over FY09. Serial currently has 100.5m warrants outstanding that will expire by 20 December 2010. Given the positive outlook of the company, we think that most of these warrants will be converted to shares, diluting EPS.

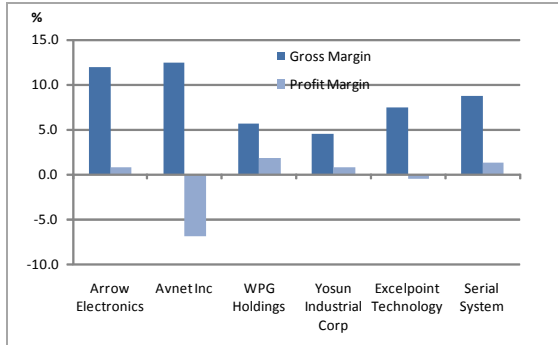
On a positive note, Serial's shareholders will enjoy a nice dividend payout of 0.51 cents a share, representing a dividend yield of 5.4% over its last close of S\$0.095. This implies a payout ratio of close to 50%. Based on our forecast profits for FY10F and FY11F, we can expect annual dividends of 0.65 cents and 0.78 cents, or a yield of 6.5% and 7.8% respectively.

**Fig12: Peer comparison by revenue, latest FY**



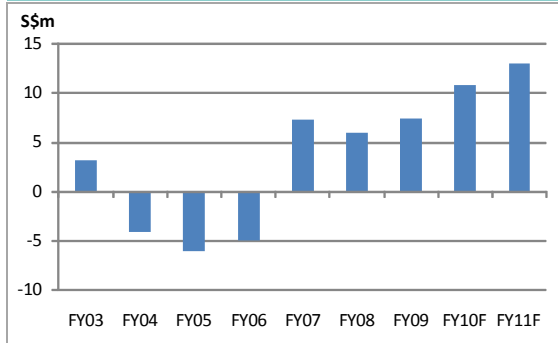
Source: Company, Google Maps

**Fig13: Peer comparison by margins, latest FY**



Source: Bloomberg

**Fig14: PATMI**



Source: Company, SIAS Research Estimate

## Peer valuation

The current consensus FY10F PER for Serial's industry peers is 12.5x on average. We value Serial at 10x FY10F EPS, at a 20% discount from the industry average to account for its lower return on assets ratio and smaller size. The derived intrinsic value of S\$0.14 is a respectable 40% above its last closed price of S\$0.100 with an implied price to FY10F book value and price to FY11F earnings of 1.1x and 8.2x respectively. Our valuation multiples price Serial significantly above Excelpoint Technology, but slightly below that of Yosun Industrial Corp; a spot that we think is reasonable.

In all, we opine that Serial System Ltd is a good investment with a well balanced strategy aimed at securing its industry position, building growth and defending margins. Moreover, the high dividend payout ratio is a nice carrot to reward shareholders. While we conjure that Serial may eventually hit the S\$1bn mark in sales, it is still a comparatively small player for now. Hence, we initiate on Serial with an Invest call and intrinsic value of S\$0.14 - representing an upside of 40%.

**Fig15: Valuation**

	<b>Fwd PER</b>	<b>P/BV</b>	<b>ROE(%)</b>	<b>ROA(%)</b>	<b>Debt to Equity(%)</b>
Arrow Electronics Inc	11.8	1.2	4.4	1.7	48.0
Avnet Inc	12.7	1.5	-33	-16	35.1
WPG Holdings Co Ltd	13.3	2.7	20	6.8	83.1
Yosun Industrial Corp	12.0	2.2	11	4.4	63.7
Excelpoint Technology Ltd	NA	0.5	-4.2	-1.5	48.6
<b>Average</b>	<b>12.5</b>	<b>1.6</b>	<b>-0.3</b>	<b>-0.8</b>	<b>55.7</b>
<b>Serial System Ltd</b>					
<b>FY10F</b>					
ROE (%)	10.9				
ROA (%)	5.4				
EPS	1.42				
Current Debt to Equity (%)	50.4				
PER mutiple	10.0				
<b>Intrinsic value (cents)</b>	<b>14.0</b>				
Implied FY10F P/BV	1.1				
Implied FY11F PER	8.2				

Source: Bloomberg, SIAS Research Estimate

**Fig16: Financial Forecast and Estimate**

	FY07	FY08	FY09	FY10F	FY11F
Revenue	476.2	510.6	556.5	640.0	736.0
Gross Profit	41.5	46.7	48.6	57.0	65.5
Operating Profit	9.4	8.5	9.0	13.0	15.7
Net Profit Attributable to Shareholders	7.3	6.0	7.5	10.8	13.0
Total Current Assets	148.5	114.2	161.0	175.9	192.2
Total Non-Current Assets	32.9	33.0	39.5	40.0	40.5
Total Current Liabilities	90.7	63.7	99.4	99.9	109.6
Total Non-Current Liabilities	10.7	2.5	7.5	7.5	7.5
Total Equity	80.0	81.0	93.5	108.5	115.6
Cash from Operating Activities	3.5	17.7	(3.7)	9.3	11.8
Cash from Investing Activities	18.5	(3.4)	(10.0)	(2.2)	(2.2)
Cash from Financing Activities	(14.1)	(12.4)	18.5	(6.7)	(7.8)
Net change in cash	7.9	1.9	4.8	0.5	1.8
Inventory Days	53	42	40	45	42
Receivable Days	48	44	41	42	41
Payable Days	48	38	33	40	40
ROE (%)	9.1	7.6	8.7	10.9	11.9
ROA (%)	4.1	4.0	4.5	5.4	6.1
Debt/Equity (%)	47.3	38.2	50.4	35.1	33.1
Current Ratio	1.6	1.8	1.6	1.8	1.8
EPS (S cents)	1.9	1.0	1.1	1.4	1.7
BV/Share (S cents)	21.0	13.4	12.9	12.8	13.6
PER	5.2	10.0	9.0	7.1	5.8
P/BV	0.5	0.7	0.8	0.8	0.7

Source: SIAS Research Estimate

**Rating Definition:**

**Increase Exposure** – The current price of the stock is significantly lower than the underlying fundamental value 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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**SIAS Research Pte Ltd received compensation for conducting this valuation research. The estimated fair value of the stock is statement of opinion, and not statement of fact or recommendation on the stock.**

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