Sarine Technologies

Industrials

15 May 2019

Focus on cost savings and marketing efforts

As the midstream market continues to struggle, Sarine reported a net loss of US$1.4m in Q119 amid weaker scanning activity and lower margins on equipment sales. In this environment, the company is focusing on prudent cost management and further promotion of retail-oriented products (which remains a minor part of the business at just under 3% of Q119 group sales). Management has recently seen some initial signs of potential recovery in the number of scanned stones. The company retained a solid gross cash position of US$32.7m (vs US$28.9m at end-2018).

Significant decline in Q119 recurring revenue

Sarine reported a 34.4% y-o-y decline in revenues to US$10.9m in Q119, with recurring revenues from inclusion mapping services down c 20% y-o-y. Although the company was able to deliver 33 new systems, these exclusively represented models for scanning smaller stones, which are sold at a lower margin. As a result of these factors, Sarine's gross margin declined to 56.2% in Q119 from 68.2% in Q118 and the company booked an EBIT loss of US$0.8m (vs US$3.6m profit in Q118). Diluted loss per share came in at 0.40c (Q118: 0.88c of profit).

Operating costs kept under control

Sarine's overall operating expenses declined in Q119 by 11% y-o-y to c US$7.0m. We understand that the reduction is predominantly a function of the management's emphasis on keeping the cost side constrained. These measures have offset the higher costs associated with the reorganisation and expansion of the sales team in AsiaPac. Having said that, Sarine's marketing plan for 2019 aimed at promoting its rough diamond planning and manufacturing technology and retail-oriented products remains intact. Sarine's G&A expenses went up sequentially to US$1.6m from US$1.4m in Q418 as they started to reflect the trial phase of its patent litigation.

Valuation: Shares offering a c 6% dividend yield

Sarine's shares are traded at FY18 adjusted P/E and EV/EBITDA multiples of 10.8x and 4.1x, respectively. These ratios represent a 57% and 72% discount to the laboratory and site-based materials analysis and testing business, respectively. The company's current temporary dividend policy at one US cent every six months translates into a dividend yield at 6.25% on an annualised basis. The policy has been communicated during the FY18 results release as a response to higher sales and marketing expenses expected in 2019 and weak industry performance.

Historical financials

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	22.7	12.8
12/16	72.5	22.0	5.14	4.50	4.5	19.2
12/17	58.6	9.4	1.64	3.50	14.2	15.0
12/18	58.5	10.1	2.17	3.00	10.8	12.8

Source: Sarine Technologies accounts

Price	**S$0.32**
Market cap	**S$112m**
	US$/S$1.37

Share price graph

Share details

Code	SARINE.SP
Listing	SGX
Shares in issue	350.6m
Last reported net cash at end-March 2019 (net of lease liabilities)	US$25.5m

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 net cash position.

Bear

- Challenging environment for midstream manufacturers.
- Copyright infringement.
- Risk associated with lab-grown diamonds

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Q119 results highlights: Environment still tough

Sarine reported a net loss of US$1.4m in Q119 (versus a US$3.1m net profit in Q118), with group sales decreasing by 34.4% y-o-y to US$10.9m. This is in line with the statement included in the company's profit warning issued on 18 April, where management highlighted the continued difficult situation in the Indian diamond midstream sector. The factors weighing on the industry have been extensively discussed in our prior update notes and include: 1) working capital issues resulting from tightening of bank funding, with Indian banks recently calling for return of part of the existing loans towards the end of the Indian fiscal year ending March, reducing credit lines to manufacturers by c 20–30% according to Sarine; 2) weak Indian rupee versus the US dollar exacerbating the working capital shortfall; 3) competitive threat from lab-grown diamonds; and 4) the US-China trade dispute affecting Chinese consumer demand.

The above has translated into lower recurring revenues from inclusion mapping services (down 20% y-o-y, still representing more than 55% of group sales), even though these remained quite resilient in 2018 despite external headwinds. The reduction was driven by lower manufacturing activity in the midstream, which was accompanied by lower volume of rough diamonds entering the pipeline. During the first two cycles of DeBeers sights this year, rough diamond sales declined by 26% and 19%, respectively, while the third cycle saw a more normalised sales level at US$575m (provisional figure), up c 10% y-o-y (although from a low comparative base last year). The drop in Alrosa's sales was even stronger at 33% in the first four months of 2019. More recently, Sarine experienced a rebound in scanning activity and reached a record level on several days in excess of 50,000 scans. This may constitute potential initial signs of recovery, although we believe it is too early to draw a final conclusion.

Sarine's retail-oriented revenue represented just under 3% of group revenues in Q119, compared to around 2% in prior periods. In April 2019, the company announced that New Art CIMA, a leading bridal jewellery retail chain, has decided to introduce Sarine Diamond Journey. This includes its latest feature, 3D-Origin, which is a 3D-printed model of the actual rough stone from which the polished diamond was derived. This follows the announcement in February 2019 of the adoption of Sarine Diamond Journey by Schachter & Namdar, a diamond supplier and DeBeers sight holder in Namibia. This product should be assisted by the increased emphasis put on diamond provenance and traceability. The company has highlighted that it aims to onboard further midstream suppliers to the process, which will allow for a more comprehensive rollout with retail customers.

In Q119, Sarine delivered 33 Galaxy-family systems (compared to 12 systems in Q118), including 29 Meteorite and four Meteor models (all delivered in India), bringing the total installed base to 443 units. However, it must be noted that both models are systems for scanning smaller stones and are characterised by a lower unit price and gross margin in comparison to the systems for larger stones. As a result, equipment sales by value were down and, together with lower scanning activity, led to a significant decline in Sarine's gross margin to 56.2% in Q119 from 68.2% in Q118.

Amid the demanding market conditions, Sarine continued to focus on prudent cost management. In line with the trend in prior periods, R&D expenses continued to decline and at US$2.1m were 22.6% down y-o-y. This was largely the result of lower employee compensation and outsourcing expenses. At the same time, sales and marketing expenses fell 6.0% y-o-y to US$3.2m due to lower marketing and trade show expenses and the lack of incentive-based compensation accruals (partially offset by higher sales compensation expenses in the APAC region to drive Sarine's retail-oriented products adoption). G&A costs declined 2.1% y-o-y to US$1.6m but were up sequentially as the company entered the trial phase of its patent litigation. Consequently, Sarine booked an EBIT loss of US$0.8m in Q119 (vs a US$3.6m profit in Q118). It is worth noting the Q119 operating profit figure was influenced by the adoption of IFRS 16.

Exhibit 1: Financial highlights

US$000s, unless otherwise stated	Q119	Q118	y-o-y
Revenues	**10,922**	**16,661**	**-34.4%**
Cost of sales	(4,789)	(5,295)	-9.6%
Gross profit	**6,133**	**11,366**	**-46.0%**
Gross margin	*56.2%*	*68.2%*	*-1,207 bps*
Research and development costs	(2,066)	(2,668)	-22.6%
Sales and marketing expenses	(3,248)	(3,455)	-6.0%
General and administrative expenses	(1,644)	(1,679)	-2.1%
Operating profit	**(825)**	**3,564**	**N/M**
EBIT margin	*(7.6%)*	*21.4%*	N/M
Net finance income (expense)	(161)	24	N/M
Income taxes	(424)	(480)	-11.7%
Post-tax profit	**(1,410)**	**3,108**	**N/M**
Diluted EPS (c)	**(0.40)**	**0.88**	**N/M**

Source: Sarine Technologies, Edison Investment Research

Despite the reported net loss, Sarine's gross cash position remains firm at US$32.7m (up from US$28.9m at end-2018), which was assisted by the reduction in trade receivables translating into operating cash flow at US$4.3m in Q119 (vs US$6.6m in Q118). Following IFRS 16 adoption, Sarine recognised finance lease liabilities of US$7.2m on its balance sheet.

Valuation

Sarine's valuation is mainly dependent on improvement in the midstream diamond manufacturing sector and the company's expansion in the downstream segment, which should support earnings growth and improvements in profitability and returns. Sarine's current LTM ROE stands at just 4.5% and the return towards 2014 levels of 34% seems unlikely in the immediate future, given the current unfavourable market environment.

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 (for a detailed description, please see our previous update note). Although we acknowledge these companies operate in different markets from Sarine, we have identified some similarities to Sarine's activities.

Sarine trades on a 2018 P/E of 10.8x when adjusted for the US$0.5m write-down of deferred and other tax assets recognised in Q418. This translates into a 57% discount to the peer group. At present, there are no consensus estimates available for the company.

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 Sarine's current exposure to the retail business is just under 3% 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, which is likely a reflection of their very strong brands and market positions in jewellery retailing.

Exhibit 2: Peer group comparison

	Market cap	P/E (x)			EV/EBITDA (x)		
	(local ccy m)	2018	2019e	2020e	2018	2019e	2020e
Bruker Corporation	US$6,533	36.4	25.8	23.4	20.0	16.2	14.8
Bureau Veritas	€9,294	22.3	20.4	18.7	12.9	12.1	11.4
Spectris	US$2,938	15.9	14.5	13.6	11.4	10.7	10.0
Intertek	US$8,052	24.9	23.7	22.0	15.5	14.3	13.4
Peer group average	**-**	**24.9**	**21.1**	**19.4**	**14.9**	**13.3**	**12.4**
Sarine Technologies	S$112	10.8*	N/A	N/A	4.1	N/A	N/A
Premium/(discount)	**-**	**(57%)**	**N/A**	**N/A**	**(72%)**	**N/A**	**N/A**
Chow Tai Fook	HK$74,100	17.6	16.8	15.1	11.7	10.8	16.2
Tiffany & Co	US$11,860	18.2	19.6	18.2	11.8	11.3	18.5

Source: Company accounts, Refinitiv consensus as at 14 May 2019. Note: *Sarine's FY18 P/E is adjusted for the US$0.5m write-down of deferred and other tax assets.

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