

INITIATION REPORT

4 April 2011

K-One Technology Bhd

Price : RM0.40

Market Capitalization : RM 135.0mln

Board : ACE Market

Sector : Technology

Recommendation : BUY

Bursa/ Bloomberg Code: 0111 / KONE MK
Stock is Shariah-compliant.**Key Stock Statistics**

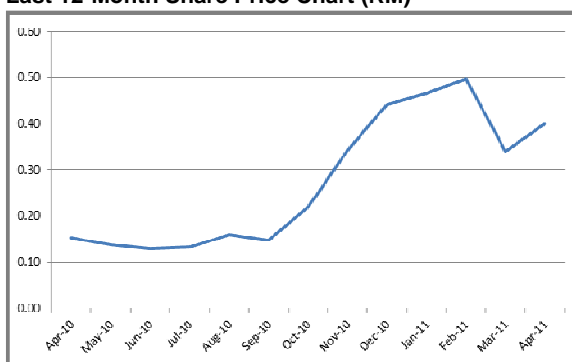
FYE Dec	FY09	FY10	FY11E
EPS (sen)	0.96	5.93	4.16
P/E (x)	41.0	6.7	9.5
Dividend/Share (sen)	0.00	0.00	1.00
NTA/Share (sen)	32.0	37.2	18.4
Book Value/Share (sen)	35.8	41.3	20.3
Issued Capital (m shares)	133.4	135.7	341.9
52-week Hi-Low (RM)	0.28 - 0.51		

Major Shareholders (%):

Ir. Lim Beng Fook	21.05
Lim Soon Seng	16.08
Bjørn Bråten	13.47

Per Share Data

FYE Dec	FY09	FY10	FY11E
Book Value (RM)	35.8	41.3	20.3
Cash Flow (sen)	2.96	8.09	5.63
Earnings (sen)	0.96	5.93	4.16
Dividend (sen)	-	-	1.00
Payout Ratio	-	-	0.24
P/E (x)	41.0	6.7	9.5
P/Cash Flow (x)	13.4	4.9	7.0
P/Book Value (x)	1.1	1.0	1.9
Dividend Yield	0.0%	0.0%	2.5%
ROE	2.7%	14.3%	20.5%

Last 12-Month Share Price Chart (RM)

* Source: Bloomberg

Investment Highlights / Summary

- **K-One is a fast growing design driven electronic manufacturing services company.** It has secured the niche markets for the outsourcing of mobile phone accessories, computer peripherals and consumer technology products to global players.
- **Set to reap the benefits of economies of scale.** After 10 years in the business, the annual revenue base has reached the level that commensurate to the expanded capacity made available by its network of vendors and manufacturers. Henceforth, profitability will be more reflective of revenue growth, even with lower gross margins.
- **Profit growth is expected to outperform revenue growth** as; not only will economies of scale apply; products currently manufactured are those at the beginning of their life cycles whose accelerating revenue growth will produce a double-whammy effect.
- **Borrowings under control.** Current net gearing is at a reasonable 0.35X. With business set to expand further there is ample room for gearing to increase.
- **Risks.** Revenue is dependent on a few customers and any setbacks suffered by these customers will have a direct impact on profits. Raw material prices are rising and volatile which could lead to supply interruptions and/or pricing pressure.
- **Recommend** a BUY with a target price of RM0.50. Based on our FY2011 forecast, this will value K-One on a P/E of 12X, which is the average of its global peers.

Background

Electronics Manufacturing Services (EMS)

K-One Technology Berhad (K-One) is one of several independent global provider of customized and integrated EMS. These companies provide comprehensive services primarily to original equipment manufacturers (OEMs), in the communications, enterprise computing and storage, multimedia, industrial and semiconductor capital equipment, defense and aerospace, medical, renewable energy and automotive industries.

Historically, EMS companies generally manufacture only components or partial assemblies. As the EMS industry evolved, OEMs have increased their reliance on EMS companies for additional and more complex manufacturing services including design services.

The outsourced manufacturing refers to an OEM's use of EMS companies, rather than internal manufacturing capabilities, to manufacture their products. EMS companies are the principal beneficiaries of the increased use of outsourced manufacturing services by the electronics and other industries.

EMS companies now often manufacture and test complete systems and manage the entire supply chains of their customers. Industry leading EMS companies offer end-to-end services including product design and engineering, manufacturing, final system assembly and test, direct order fulfillment, aftermarket product service and support, and global supply chain management.

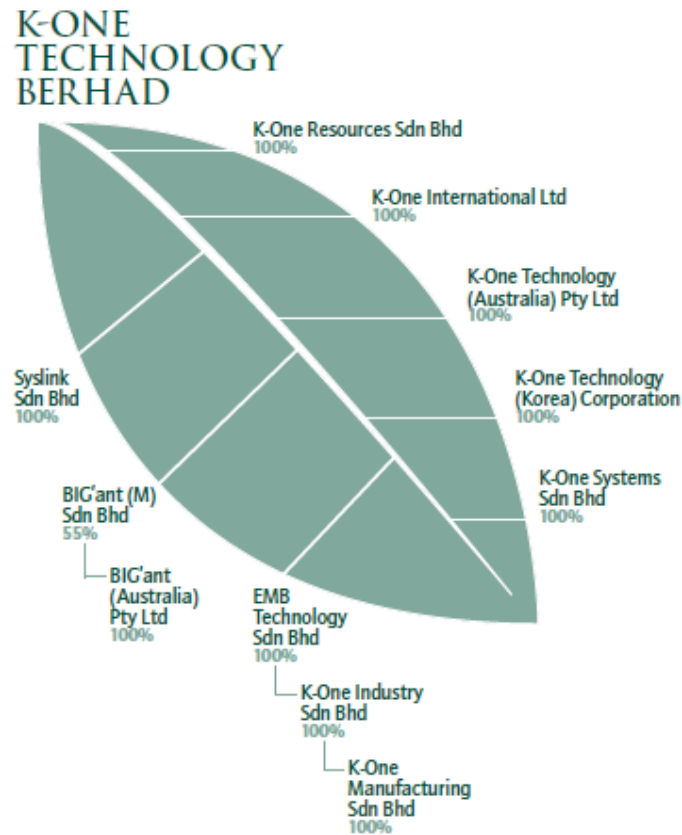
Corporate Profile

K-One started off as a design house for complete products falling in the mobile phone accessories, computer peripherals and consumer technology products space in 2001. It manifested into an EMS company but still driven by product design and development as its catalyst for growth. K-One was listed on the Mesdaq Market (now known as ACE Market) in January 2006.

The company was founded by Ir. Edwin Lim Beng Fook (53 years old, Group Executive Chairman), Martin Lim Soon Seng (48 years old, Group Chief Executive Officer) and Bjørn Bråten (53 years old, Non-Independent Non-Executive Director). Other key members of the Board are Goh Chong Chuang (57 years old, Independent Non-Executive Director) and Loi Kim Fah (44 years old, Independent Non-Executive Director).

Together, these co-founders own about 51% of the company.

Corporate Structure



Business

The Group's business activities are reported under the following business segments:

- (i) Research, design and development of electronic end-products and sub-systems for the communication, computer and consumer electronics industries.
- (ii) Manufacturing of electronic end-products and sub-systems including their design and development of manufacturing process/tools for manufactures in the above industries.

Major products are mobile phone accessories, USB cables, outdoor sports electronic headlamp, webcam, household appliances, electronic security and healthcare products.

- (iii) End-to-end solution provider of digital pen and paper (DPP) technology.

Digital pen and paper technology combines the portability of traditional pen and paper with a computer's ability to store, share, and act upon the information collected.

Customers

K-One's customers are currently in 3 business sectors, namely; mobile phone accessories, computer peripherals and consumer technology products. They are large global industry players who have assigned K-One the status of Approved Vendor.

The Approved Vendor status is a coveted and privileged position and represents a difficult barrier of entry to other companies with similar ambitions because (i) only vendors in the Approved Vendor List may bid for projects; and (ii) the time and process taken to be accorded the Approved Vendor status could be long and arduous.

To date, about 30 companies have granted K-One as their Approved Vendor with the earliest being about 10 years. However, it has only a small number of customers contributing to a significant portion of sales. For the FY2010, the 3 major customers namely Sony Ericsson, Axis Communications and Petzl contributed RM97.4m sales or 73% of total sales. Whilst in FY2009, its top 3 customers had contributed to RM53.1m or 63% of total sales.

To achieve long production runs and hence manufacturing efficiency, it is more economical to focus on a few customers.

The geographical sales breakdowns are as follows:

RM'k	2009	2010	Growth
Malaysia	10,584	13,827	31%
Europe	42,387	65,017	53%
USA	2,075	6,976	236%
Oceania	3,683	35	(99%)
North Asia *	25,402	46,927	85%
Total	84,131	132,782	58%

* Mainly China

SWOT

Rather than investing in costly manufacturing capacities, K-One took advantage of the exodus of electronic MNCs out of Malaysia in early 2000s which left the local manufacturers that made up the supporting industry with over-capacity.

Suppliers

By selecting and grooming the qualified suppliers, K-One has created its own supply chain. It thus expanded manufacturing capacity without having to incur large capital investments than otherwise.

Currently, it has approximately 300 suppliers with each benchmarking against the others to ensure quality. A majority of the suppliers are based in Malaysia while some in China. They give K-One the flexibility in coping with any sudden surge in demand.

Global Players

To give a sense of where K-One is in the hierarchy of global players, we list below the major EMSs;

Name	FYE	Sales (USD'm)
K-One	Dec-2010	46
Nam Tai Electronics Inc	Dec-2010	534
CTS Corp	Dec-2010	553
Plexus Corp	Sep-2010	2,013
Sanmina-SCI Corp	Sep-2010	6,319
Celestica Inc	Dec-2010	6,526
Jabil Circuit Inc	Aug-2010	13,409
Flextronics Intl Ltd	Mar-2010	24,111

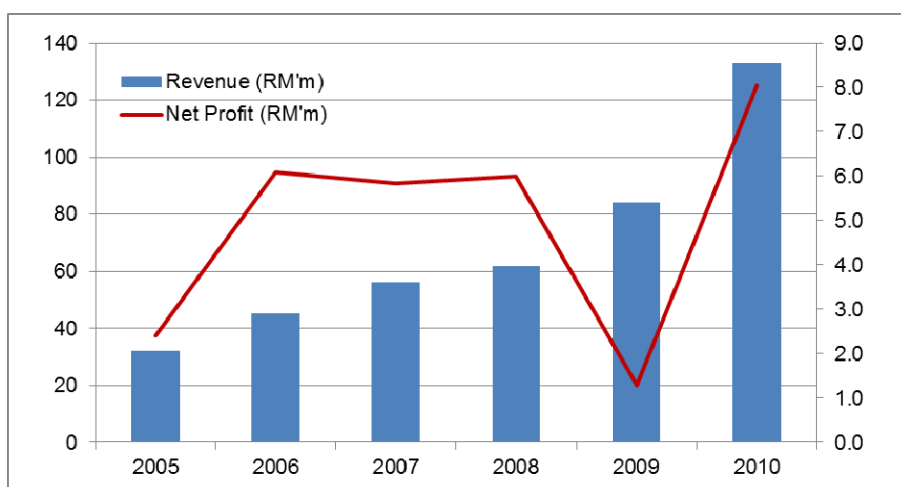
* Source - Bloomberg; exchange rate - USD1.00=RM3.03

The largest, Singapore based Flextronics has manufacturing bases in 30 countries in all the continents, and compete for business across all spectrums of the electronics industry. At this level, competition is intense and margins are small, although revenues are huge, as these big players need to support their huge base of operations.

Amongst small players in the same league as K-One (many of whom are not yet listed), the focus instead is in finding a niche where their expertise and pricing give them the competitive edge. In the case of K-One, it is the 3 major businesses that they have been servicing since 2001.

Financial Highlights ~ Achieving Economies of Scale

Audited Revenue & Net Profit (FYs 2005-2010*)



* Based on the unaudited results of 2010

In FY2010, K-One's revenue jumped RM48.7m or 58% from RM84.1m to RM132.8m after registering double-digit growth of 36%, 11% and 24% in FY2009, FY2008 and FY2007 respectively.

Gross profit margin peaked at 28.5% in FY2008 compared to 13.5% in FY2005, whilst the ratio of sales to overheads hit a low of 5.13x compared to 15.7x, respectively. The ratios have moderated to 19.4% and 8.0x in FY2010, and are expected to remain stable over the next few years.

Despite rising revenues, net profit margins show a declining trend over the past 6 years. It was mainly due to the higher overheads incurred in anticipation of high growth with the intent of achieving economies of scale.

K-One has successfully posted net profits for the last 6 financial years. In FY2009, it recorded approximately RM1.3m net profit despite a RM4.8m loss in foreign currency hedging account. Adjusting for this non-recurring item, the net profit for FY2009 would have been normalized to RM6.1m, in line with the numbers in FYs 2006-2008 (RM6.0m, RM5.9m and RM6.2m respectively). This was a noteworthy achievement during the global economic downturn period.

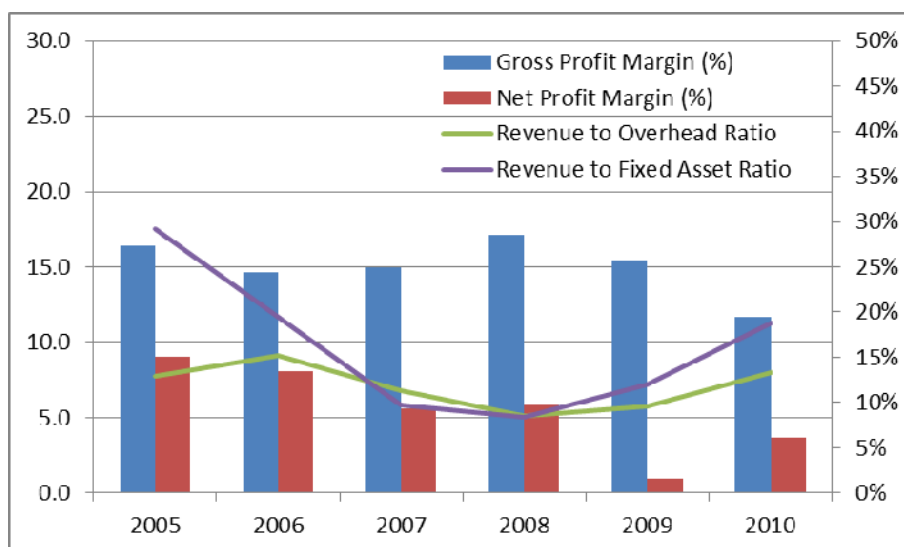
In FY2010, its revenue and net profit hit a record high of RM133m and RM8.0m (inclusive of RM1.2m bad debt provision) respectively.

Income Statement

FYE 31 st Dec	FY05	FY06	FY07	FY08	FY09	FY10
RM'm						
Revenue	15.9	45.4	56.1	61.9	84.1	132.8
Gross profit	4.4	11.1	14.0	17.7	21.6	25.8
Overheads	-2.0	-5.0	-8.3	-12.1	-14.6	-16.6
Interest expenses	0.0	-0.1	-0.4	-0.6	-1.1	-1.2
Exceptional loss*					-4.9	
Provision						-1.2
Other expenses/income	0.0	0.0	0.0	1.4	0.0	1.3
Pretax profit	2.4	6.0	6.0	6.4	1.1	8.0
Tax	0.0	0.0	-0.1	-0.2	0.1	-0.1
Minorities	0.0	0.1	-0.1	-0.2	0.2	0.1
Attributable Profit	2.4	6.1	5.8	6.0	1.3	8.0
Ratios & Margins						
Revenue/Overheads	15.8	9.1	6.8	5.1	5.8	8.0
Gross margin	27.7%	24.4%	25.0%	28.5%	25.7%	19.4%
Net margin:						
Before*	15.1%	13.4%	9.3%	9.7%	7.3%	6.9%
After*	15.1%	13.4%	9.3%	9.7%	1.5%	6.1%

* Before and after loss in forex hedging contracts for FY2009 and provisions for FY2010

Margins & Turnovers



Balance Sheet

As at 31 st Dec (RM'm)	FY05	FY06	FY07	FY08	FY09	FY10
Total assets	22.8	36.1	63.8	81.9	97.9	115.3
Fixed assets	0.9	3.9	9.6	12.2	11.7	11.8
Intangible assets	-	0.0	5.9	6.5	6.4	6.4
Cash & bank balances	7.4	5.0	7.9	6.5	6.8	7.5
Bank borrowings	2.3	3.8	9.9	21.6	26.6	26.3
Shareholders' equity	13.3	19.2	40.3	46.2	47.8	56.0
Minority interest	-	-	0.1	0.3	0.5	-
Net gearing (x)	Net cash	Net cash	0.1	0.3	0.4	0.3

K-One has maintained a healthy balance sheet over the 6 years. It has a low net gearing due to its relatively strong cash position and low borrowings.

Its borrowings increased by RM6.1m, RM11.7m and RM5.0m in the FYs 2007-2009 respectively up to RM26.3m as of FYE2010, in tandem with its fixed assets profile.

Cash Flow

FYE 31st Dec	FY05	FY06	FY07	FY08	FY09	FY10
RM'm						
CFO before working capital changes	2.5	7.0	7.2	8.8	4.7	12.0
Net operating cash flow	-2.4	-0.4	-0.2	-6.3	-4.9	-2.2
Net changes in cash	5.6	0.6	-0.9	-2.7	3.4	2.4

K-One has sustainable positive cash flow from operation (before working capital) over the 6 years. However, its expansion projects had tied-up approximately RM20m cash in working capital during the FYs 2009-2010.

Earnings Outlook

A double-whammy effect from economies of scale and products at the beginnings of life cycle

Now that the management set-up to handle the high capacity production system is in place, K-One's objective is to be even more aggressive in maximizing sales volume.

Customers generally provide K-One with forecasts of their expected off takes a year in advance of production. Also its large network outsourced vendors and manufacturers are able to cope with any unexpected surge in demand.

Based on these, K-One is expecting to achieve revenue of approximately RM178m in FY2011. This represents a 34% increase from that in 2009, slightly lower than that achieved for 2009 (58% growth). The increase comprises new products from existing customers, production for a new customer and increases from products already in manufacture.

Cost of sales comprises mainly raw materials. The main raw materials are plastics and metals both of which have seen their prices rising.

K-One, being one of the few without a vertically integrated manufacturing set-up is exploiting this spare capacity from its outsourced networks for lower manufacturing costs. This should be possible given the higher throughput that it will be passing to them.

Overhead costs are expected to reflect normal wage adjustments as the current set-up is already capable of handling even much higher throughput than this.

K-One is awarded with MSC-Status, which carries with it tax exemption until 2012. It is expecting a net profit margin of 8%, which is the average for the past 5 years.

Based on the above, our calculations show that K-One will be able to report a net profit of RM14.2m for FY2011.

Profitability Analysis

FYE Dec	FY09	FY10	FY11E
RM'm			
Revenue	84.13	132.78	177.68
EBITDA	3.95	10.97	15.57
Depreciation& Amortisation	-1.81	-1.78	-3.19
Finance costs	-1.08	-1.21	-1.39
Pre-tax profit	1.05	7.98	14.65
Attributable profit	1.28	8.04	14.21
EBITDA margin	4.7%	8.3%	8.8%
Effective tax rate	6.0%	-1.6%	-3.0%
Net margin	1.5%	6.1%	8.0%

Investment Risks

The main risks to our forecasts are as follow:

1. Sales are dependent on a few customers; any setbacks suffered by these customers will have a direct impact on K-One's profitability.
2. Fluctuating raw material prices may lead to supply disruptions and pricing pressure.
3. Manufacturing costs would offset the impact of rising raw material prices. Manufacturing costs may go up if the global economy recovers at a much quicker pace, or manufacturers close down their operations permanently thereby reducing available capacity.

Valuation**Peer Comparison**

Name	Year End	Market Cap (USD'm)	Price (USD)	Forward P/E
K-One	Dec	45	0.13	
Sanmina-SCI Corp	Sep	842	10.50	7.3
Flextronics Intl Ltd	Mar	5,480	7.21	9.5
Jabil Circuit Inc	Aug	4,050	18.59	10.1
Celestica Inc	Dec	2,228	10.35	12.0
Plexus Corp	Sep	1,188	29.30	13.0
CTS Corp	Dec	351	10.23	13.8
Nam Tai Electronics Inc	Dec	278	6.21	15.1
Average excluding K1				11.6
Exchange rate		USD1=RM3.03		

* Source – Bloomberg, as at 18 March 2011, except for K-One which is 4 April 2011

By the beginning of 2010, demand for OEMs' end products started improving. We believe that the long-term growth prospects for outsourcing of advanced manufacturing capabilities, design and engineering services and after-market services would remain positive.

Recommendation - BUY

We are assigning a forward P/E of 12X to K-One. This P/E is the average of its major global peers. Current illiquidity is mitigated by the recently increased outstanding shares in issue and the higher expected EPS growth for the next few years.

Our forecast EPS of 4.16 sen for FY2011 gives us a valuation of RM0.50, representing an upside potential of 26% or a BUY.

RATING GUIDE

BUY	Price appreciation expected to exceed 10% within the next 12 months
SELL	Price depreciation expected to exceed 10% within the next 12 months
HOLD	Price movement expected to be between -10% and +10% over the next 12 months from current level

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