

INITIATION REPORT

27 July 2011

SMR Technologies Bhd

Price : RM0.15

Market Capitalization : RM 22.0mln

Board : ACE Market

Sector : Technology

Recommendation : BUY

Bursa / Bloomberg Code: 0117 / SMRT MK
Stock is Shariah-compliant.

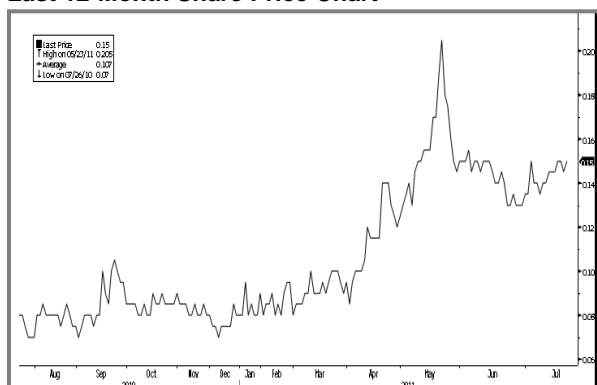
Key Stock Statistics

| FYE Dec | FY10 | FY11f |
|-----------------------------|---------------|-------|
| EPS (sen) | 0.2 | 2.6 |
| P/E (x) | 78.9 | 5.7 |
| Net Div/Share (sen) | - | - |
| NTA/Share (RM) | 0.02 | 0.03 |
| Book Value/Share (RM) | 0.19 | 0.19 |
| Issued Capital (mln shares) | 146.7 | |
| 52-week Hi-Low (RM) | 0.065 - 0.205 | |
| Major Shareholders: | | |
| Special Flagship Hldgs S/B | 32.2% | |
| Fikir Waw asan S/B | 15.9% | |

Per Share Data

| FYE Dec | FY09 | FY10 | FY11f |
|--------------------|-------|------|-------|
| Book Value (RM) | 0.19 | 0.19 | 0.20 |
| Cash Flow (sen) | 0.6 | 1.5 | 2.6 |
| Earnings (sen) | (1.9) | 0.2 | 2.6 |
| Net Dividend (sen) | - | - | - |
| Payout Ratio (%) | 0.0% | 0.0% | 0.0% |
| PER (x) | nm | 78.9 | 5.7 |
| P/Cash Flow (x) | 25.2 | 9.9 | 5.7 |
| P/Book Value (x) | 0.8 | 0.8 | 0.8 |
| Dividend Yield (%) | - | - | - |
| ROE (%) | nm | 1.1% | 15.5% |
| Net gearing (x) | 0.1 | 0.1 | 0.3 |

Last 12-Month Share Price Chart



Investment Highlights / Summary

- **Integrated HR solutions provider** offering comprehensive products and services ranging from software, consulting, outsourcing, learning and talent search. Its solutions focus on the strategic HR development aspect rather than the transactional aspect such as payroll or time-keeping.
- **Turnaround story.** SMR was adversely affected during the 2008/09 credit crisis which coincided with its mistimed expansion into the US market, resulting in the Group suffering losses in FY08 and FY09. However, it has since exited the US market, and shifted its focus to the ASEAN and Middle East regions. The realignment efforts paid off with SMR returning to the black in FY10.
- **Growth catalysts.** SMR clinched a 3-year project worth RM89.5 mln in September 2010 from the MOE in Malaysia (ELT Project). This project is significant as it propels the Group's revenue base to the next level while lifting earnings back to pre-crisis level. Additionally, earnings contributions from the ASEAN and Middle East markets are on the rise too.
- **Risks** include potential changes to regulatory policy that may impact the ELT Project. SMR is also exposed to country and political risks of the countries that it has operations in.
- **Substantial earnings growth.** We estimate FY11 net profit to surge to RM4.2 mln from RM0.3 mln in FY10, attributable to contribution from the ELT project, as well as its overseas jobs. Furthermore, its current orderbook in excess of RM90 mln provides earnings visibility for the next three years.
- **Initiate coverage with Buy recommendation and a fair value of 21 sen** by pegging FY11 net profit against 8x PER multiple. We view SMR as a turnaround story with strong earnings growth prospects over the next three years, supported by its local and overseas projects. Current valuation, at FY11 PER of 5.7x, is also undemanding and has yet to reflect its growth potential, in our opinion.

Background

Corporate profile

Provider of HR solutions for human capital

Kuala Lumpur-based SMR Technologies Bhd (SMR) is an investment holding company while its subsidiaries are principally involved in the provision of Human Resources (HR) solutions for the development of human capital. SMR has been listed on the ACE Market (previously known as the MESDAQ Market) of Bursa Malaysia since March 2006.

Offers comprehensive products & services

The SMR Group, founded by Dato’ Dr. R Palan, was established in 2001 although its flagship software product, HRDPower™, has a longer history where it was first developed in 1998 by Dato’ Dr. Palan. SMR started initially as a HR competency management solutions and HR outsourcing services Group that operates on the HRDPower™ software system. Over the years, SMR’s scope of offerings has expanded rapidly and today, its products and services encompass the areas of Learning & Development, Learning Resources, Consultancy, Outsourcing, Events, Talent Search, as well as Software and Technical Services.

Presently, Dato’ Dr. Palan continues to helm SMR as the Chairman and Chief Executive Officer. Being an internationally recognized HR expert and an author of 12 books on HR-related subject, he also serves as the brand ambassador for the Group. Other members on the SMR’s board of directors include another Executive Director (Dr Nadarajah A/L Manickam) and three Independent Directors.

In terms of shareholdings, substantial shareholders in SMR are Special Flagship Holdings Sdn Bhd (38.2%) in which Dato’ Dr Palan is a major shareholder, and Fikir Wawasan Sdn Bhd (15.9%).

Corporate structure.



Business

SMR provides a comprehensive range of HR development (HRD) solutions, as illustrated in the table below:

| | |
|---|--|
| Learning & Development <ul style="list-style-type: none"> • Train-the-Trainer Practice • Competency & Performance Practice • Leadership Practice • Personal Growth Practice | Talent Search <ul style="list-style-type: none"> • Search, Selection & Placement |
| Learning Resources <ul style="list-style-type: none"> • Print Products • Digital Products • Training Tools • Audio/Visual Products | Special Projects <ul style="list-style-type: none"> • English Language Training (ELT) |
| Consulting <ul style="list-style-type: none"> • Human Capital Audit • Competency Management • Competency Profiling • Competency Assessments • Talent Management & Succession Planning • Learning & Development Management • Learning Needs Analysis • Curriculum Design • Evaluation of Training • Performance Management System (PMS) | Software & Technical Services <ul style="list-style-type: none"> • HRDPower.net Enterprise System <ul style="list-style-type: none"> • Employee Management • Hiring Power • EPower (Competency) • Learning Power.Net® Training • Performance Power • Payroll Power • Success Power • Software as a Service (SAAS) <ul style="list-style-type: none"> • E-Appraisal • E-TMS • E-Assessment • HRDPower E-Learning <ul style="list-style-type: none"> • E-Certificate in Training Practice • HRDPower Games Combo <ul style="list-style-type: none"> • Pingo • Management Made Easy • Magic of Making Training Fun • WEB Portal / E-Commerce Products |
| Outsourcing <ul style="list-style-type: none"> • Learning & Development Services • Competency Management • Competency Assessments | |
| Events <ul style="list-style-type: none"> • The Asia HRDCongress™ • Trainers Meet Trainers® (TMT) • HR/HRD Conferences: Asia HR Bazaar | |

Focuses on the strategic aspect of HRD

The SMR Group focuses on the strategic aspects of human capital development such as competency issues, performance management and training, instead of the operational matters of HR, i.e. payroll system, staff leave management or time keeping where competition is more intense.

Flagship product: HRDPower.net™

Central to SMR's offerings is its in-house proprietary software platform, HRDPower.net system (HRDPower™), which is available as installed applications as well as Software as a Service (SaaS). Solutions available under HRDPower™ include:-

- Integrated Competency-based HR Management;
- Enterprise Performance Management;
- Talent Management;
- Succession Planning and Career Development; and
- Enterprise Dashboards.

Various advantages of HRDPower.net™

The software also supports multilingual and multi-database usage, employs advanced encryption to ensure data privacy, and can be interfaced to other existing software systems used by its clients to eliminate multiple data entry. Another key benefit of HRDPower.net® is low total cost of ownership as its licencing is based on number of employees, and there is no licensing limit for concurrent user access. HRDPower.net® can be used by clients from any industries, and SMR has had clients from the oil & gas, telecommunications, airlines, shipyards, hospitals, healthcare, retail, utilities, IT, hospitality, and education sectors.

Commercialized 3 new services in end-2010

In terms of new offerings, SMR has successfully commercialized and rolled out three new services in end-2010 following its intensive R&D efforts over the last few years. These are the SaaS, HRDPower™ E-Learning and HRDPower™ Games Combo.

Esteemed clientele

Today, SMR has worked with over 2,000 companies from various industries across 30-odd countries worldwide. Some of its key local clients include Ministry of Education (MOE), Petronas, Giant, PLUS, Mudajaya Group, Perodua, Murphy Oil Corporation, OSRAM Opto Semiconductors, SHARP and DST Group, to name a few.

Meanwhile, its current overseas clients are Abu Dhabi Polymers Company Ltd (Borouge) in UAE, Rabigh Refining And Petrochemical Company (Saudi Arabia), Ministry of Works (Bahrain), Authority for Info-Communications Technology Industry (Brunei), and Petrodar Operating Company (Sudan).

Secured contracts worth over RM95 mln in the last 12 months

In the past 12 months alone, SMR has successfully clinched a number of projects both in Malaysia as well as overseas, with a combined contract value in excess of RM95 mln. These recent wins are listed below:-

| Project | Client | Country | Curr. | Amount FCY ('000) | RM equiv. ('000) |
|---|---|--------------|----------------|-------------------------|------------------------|
| Contract for Consultancy for Competency and Talent Management Project | Abu Dhabi Polymers Company Ltd (Borouge) | UAE | USD | 1,425 | 4,275 |
| Competency Assessment Project Contract | Rabigh Refining And Petrochemical Company | Saudi Arabia | USD | 490 | 1,470 |
| Direct recruitment and management of ELT Consultants and implementation of In-Service Teachers Training for English Language Teachers | Ministry of Education | Malaysia | RM | - | 89,500 |
| Succession Management System | Ministry of Works | Bahrain | Bahrain Dinars | 98 | 819 |
| Supply, delivery, installation, configuration, commission and provision of warranty and maintenance of AITI's HRMS | Authority for Info-Communications Technology Industry | Brunei | Brunei Dollars | 130 | 301 |
| Technical Career Ladder & Competency Assessment System | Petrodar Operating Company | Sudan | USD | 128 | 385 |
| | | | | | 96,750 |

*FCY=foreign currency

Clinched ELT Project valued at RM89.5 mln

The most notable contract is the Recruitment and Management of ELT Consultants and Implementation of In-Service Teachers Training for English Language Teachers (ELT Project) awarded to SMR by the MOE in September 2010 that amounts to RM89.5 mln. This is the single largest contract bagged by SMR todate. The 3-year project, which SMR won via open tender, involves recruiting and managing up to 120 ELT Consultants to implement In-Service Teachers Training for English Language Teachers for Central and North Malaysia. We understand from management that all ELT Consultants have already been recruited and deployed, and the implementation of the programme is currently progressing on schedule.

Overseas: targets GCC and ASEAN regions

On overseas venture, SMR is focusing on the Gulf Co-operation Council (GCC) countries in the Middle East, as well as the ASEAN countries, where management believe have a strong demand for its expertise in human capital development. The Group has so far, made successful in-roads into these targeted countries and secured several projects as listed in the table earlier. To facilitate its marketing activities and customer support services, SMR has representative offices in Singapore, Bahrain and India.

Fragmented industry with various players

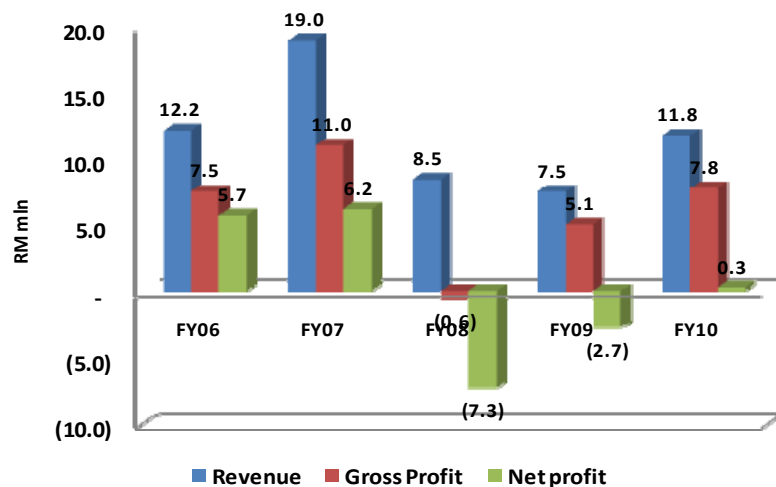
In terms of industry landscape, the HR solutions segment is rather fragmented with a number of foreign and local players. On one end, there are the large foreign players such as Oracle and SAP offering Human Resource Management System (HRMS) which target large MNC clients, while on the other end, we have smaller local companies such as KaiZenHR, Orisoft, UBS, HR2000 and Timesoft to name a few. We note that some of these peers tend to concentrate on the operational aspect of HR, i.e. payroll, time attendance and leave management. By comparison, SMR’s HRDPower® solutions focus instead on the strategic areas of HRD, i.e. performance management, talent management, staff competency etc. Furthermore, it also offers other HR-related services such as outsourcing, consultancy, talent search etc.

Financial Highlights

Healthy growth prior to credit crisis

In the two years following its listing, SMR continued to post healthy revenue and profit growth. In fact, turnover and net profit hit a record high of RM19.0 mln and RM6.2 mln, respectively, in FY07. And given the nature of its business, gross profit margin was commendably high at above 50%.

Historical Financial Performance



Suffered losses in FY08 and FY09 due to mistimed expansion into the US market

Unfortunately, the Group was hit hard in FY08 by the global credit crisis that led to lower sales and profit margin squeeze as clients hold back spending on HRD. Profitability was further affected by losses suffered at its operations in the US. Prior to the credit crisis, SMR had identified the North America as a high potential growth market and had invested time and financial resources to grow its services in there. Business slowdown, coupled with the ill-timed investment in the US resulted in the Group registering a net loss of RM7.3 mln in FY08, which saw revenue halved to RM8.5 mln from its peak level in FY07.

Returned to the black in FY10

Following a slew of cost-cutting and business optimizing measures, SMR's net loss narrowed to RM2.7 mln in FY09. Management also decided to exit from its unprofitable operations in the US by disposing off the subsidiary in April 2010. The Group finally turned around and returned to the black in FY10, chalking up a small net profit of RM0.3 mln on the back of 56% y-o-y jump in revenue to RM11.8 mln.

Robust 1QFY11 net profit surpassing FY10's full year net profit

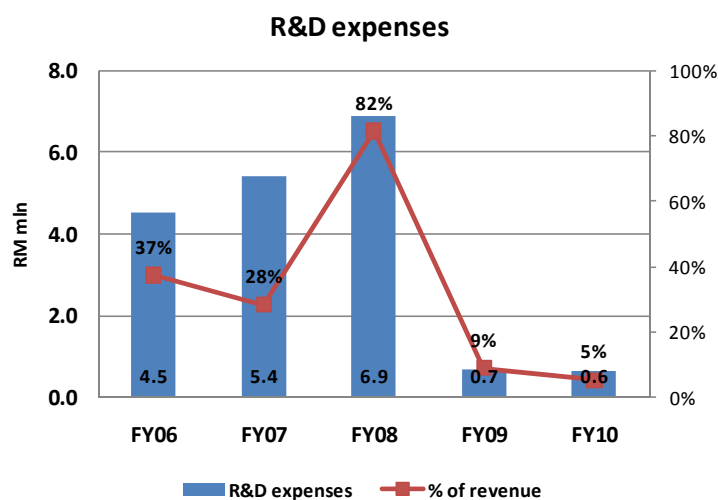
Things continue to look up for SMR with its recent remarkable 1QFY11 results with revenue soaring 59.3% q-o-q and 993.7% y-o-y to RM9.0 mln. Net profit of RM1.0 mln in 1QFY11 alone surpassed the FY10 full-year net profit of RM0.3 mln. The much better performance is largely due to overall improving business environment, and in particular, significant contribution from the ELT Project.

Relatively healthy balance sheet with net gearing of 0.3x

On balance sheet strength, net gearing remains relatively healthy at 0.25x as at end-March 2011, supported by a BV/share of 19.3 sen. Nevertheless, we note that approximately 80% of the 19.3 sen BV/share are non-tangible assets comprising goodwill on consolidation (4.5 sen/share) and development costs (10.7 sen/share), resulting in NTA/share of only 4.1 sen.

Minimal R&D expenditure going forward

The development costs are essentially capitalized R&D expenses incurred in developing new products. In the past years leading up to FY09, the Group had been spending as much as RM6.9 mln a year on R&D efforts. However, we understand from management that going forward, the R&D expenses will be kept at minimal level and on need basis only following the successful commercialization of several key products (i.e. SaaS, HRDPower® Games Combo and HRDPower® E-Learning) in late 2010.



The reduction in development spending is already noticeable, as illustrated in the table above, where it spent only RM0.7 mln and RM0.6 mln in FY09 and F10, respectively. With much lower R&D spending, we expect its NTA/share to rise gradually over time. Currently, the Group is focusing on monetizing its new products.

Earnings Outlook

Bright prospects ahead

SMR's earnings outlook over the next three years appears to be upbeat. Having exited its unprofitable venture in the US, the Group has turned around and is now firmly back on earnings growth path riding along the gradual recovery in the global economy.

Orderbook in excess of RM90 mln

SMR's contract wins of RM96.8 mln over the past 12 months are a testament that the worst is over for the Group. Its current orderbook, in excess of RM90 mln, will provide earnings visibility for the next three years. These figures are a stark contrast to its historical revenue that ranged between RM7 mln and RM20 mln per annum since listing. Additionally, we understand from management that SMR has also tendered for some RM100 mln worth of projects, mostly in the Middle East, with an estimated success rate of 20%. This would translate into a potential orderbook replenishment of RM20 mln in the next six to nine months.

Projects threefold jump in FY11 revenue

For FY11, we project revenue to jump almost threefold to RM34.5 mln from RM11.8 mln in FY10. The significant increase is mainly due to the full year contribution from the ELT Project, which averages approximately RM30 mln per annum for three years, as well as from its overseas projects. Correspondingly, we expect SMR to turn in RM4.2 mln in net profit vs. RM0.3 mln in FY10, translating into a prospective FY11 net profit margin of 12.3%. We note that our projected net profit margin is lower compared to the 30%-40% level attained prior to FY08 as we understand that the ELT Project carries lower profit margin. Nevertheless, based on our estimates and its current orderbook, SMR should achieve its highest ever revenue level in FY11 since inception.

For FY12, we forecast revenue and net profit to rise 14.3% and 14.8% y-o-y to RM39.4 mln and RM4.9 mln respectively, with growth driven by contributions from its software sales and overseas projects.

Investment Risks

Changes in regulatory policy. With the ELT Project, which was awarded by the MOE, being the single largest contract for SMR at the moment, any changes in the regulatory policy that involve the teaching of the English subject may have an unfavourable impact on the Group's earnings.

Country and political risks. The Group is also exposed to the country and political risks in the GCC region as it has several ongoing projects in the region, and plans to further grow its business there.

Valuation

There are no direct comparable companies listed on the Bursa Malaysia that have similar businesses as SMR. Previously, there were Orisoft Technology Bhd and KZEN Solutions Bhd which focused on HR solutions. However, Orisoft had since been taken private by Exact Group B.V. in 2009 while KZEN Solutions has changed name to R&A Telecommunication Bhd and exited the HR business following completion of the reverse takeover by R&A Telecommunication Sdn Bhd recently.

Peer comparison As such, we have selected several companies with exposure to the ICT and software business as a proxy benchmark for valuation comparison.

| Company | Share Price (RM) | PER (x) | P/BV (x) | Mkt Cap (mIn) | Net gearing (x) |
|---------------------|------------------|-------------|------------|---------------|-----------------|
| SMR | 0.15 | 5.2 | 0.8 | 22.0 | 0.3 |
| Century Software | 0.64 | 13.2 | 4.2 | 218.6 | net cash |
| HiTech Padu | 1.09 | 12.3 | 0.6 | 110.3 | 0.6 |
| Cuscapi | 0.43 | 10.4 | 2.1 | 94.5 | net cash |
| Grand-Flo Solution | 0.42 | 8.1 | 1.2 | 67.0 | 0.2 |
| Excel Force MSC | 0.29 | 10.6 | 1.6 | 58.9 | net cash |
| Rexit | 0.29 | 8.5 | 1.8 | 54.9 | net cash |
| EA Holdings | 0.35 | 10.3 | 2.2 | 53.5 | net cash |
| Avg excl SMR | | 10.5 | 2.0 | | |

Source: Bloomberg; respective company's latest quarterly results

Based on the selected benchmark, the peers are trading at an average PER of 10.5x. By ascribing SMR's prospective FY11 net profit of RM4.2 mln against a target PER of 8x, we arrive at a fair value of 21 sen. The target PER is derived after applying a discount of approximately 25% to the peer benchmark, to reflect SMR's smaller market capitalization.

On the corporate front, SMR is currently undertaking a private placement exercise to place out 14.7 mln ordinary shares representing 10% of its current paid up capital. It has fixed the price of the new shares at 13.3 sen per share, raising RM1.95 mln which will be used for working capital purposes. We understand the shares are being placed out to strategic investors that would add value to SMR's business prospects. The corporate exercise will increase SMR's share base to 161.3 mln from 146.7 mln. Nevertheless, the dilution to FY11 EPS is relatively marginal, from 2.7 sen to 2.6 sen.

Recommendation

Buy call with fair value of 21 sen We initiate our coverage on SMR with a **BUY** recommendation and a fair value of **21 sen**, translating into a potential share price upside of 40%.

In our opinion, SMR offers a strong turnaround story with solid earnings growth prospects. The financial performance turned around following the decision to exit the unprofitable US market. Moving forward, the growth catalyst lies in the 3-year ELT Project, which gives the much needed booster to elevate SMR's revenue base to the next level while lifting earnings back to the pre-crisis level. Additionally, the new revenue base is also supported by the Group's rising contribution from its overseas projects. We also take comfort that the management, led by Dato' Dr. Palan, is very experienced and hands-on.

Undemanding valuation

We believe SMR's current valuation at FY11 PER of 5.7x is also undemanding and has yet to reflect its growth potential. Furthermore, with the expected significant improvement in earnings, we opine there could be a possibility of SMR resuming its dividend payout. The Group last paid a 1 sen dividend in 2007 in respect of FY06, and has not had any payout since. A 0.5 sen dividend payout would translate into a yield of 3.3% while a 1 sen payout would push yield to 6.7%. Nevertheless, in reflecting prudence in our projection, we have not factored in any dividend payout at this juncture.

P&L Summary

| FYE Dec (RM mln) | FY09 | FY10 | FY11f | FY12f |
|-------------------------|-------------|-------------|--------------|--------------|
| Revenue | 7.5 | 11.8 | 34.5 | 39.4 |
| EBIT | (1.7) | 0.6 | 5.3 | 6.3 |
| Net Int Exp | (0.2) | (0.2) | (0.7) | (0.9) |
| Pre-tax Profit | (1.9) | 0.4 | 4.6 | 5.4 |
| Eff. Tax Rate | nm | 64.8% | 12.0% | 12.0% |
| Net Profit | (2.7) | 0.3 | 4.2 | 4.9 |
| EBIT Margin (%) | nm | 4.9% | 15.5% | 15.9% |
| Pre-tax Margin (%) | nm | 3.3% | 13.5% | 13.6% |
| Net Margin (%) | nm | 2.4% | 12.3% | 12.3% |

Source: Company, ZJ Research

Balance Sheet Summary

| FYE Dec (RM mln) | FY09 | FY10 |
|-------------------------|-------------|-------------|
| Total Assets | 32.7 | 36.4 |
| Non-Current Assets | 30.4 | 28.6 |
| Current Assets | 2.3 | 7.8 |
| Current Liabilities | 7.1 | 9.0 |
| Long Term Liabilities | 0.2 | 0.2 |
| Share Capital | 13.3 | 14.7 |
| Shareholders' Equity | 25.7 | 27.3 |

Source: Company

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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ZJ Advisory Sdn Bhd (Co No: 645449-V)
(An investment adviser licensed by the Securities Commission)
Suite 22B, 22nd Floor, Sunway Tower,
No 86, Jalan Ampang, 50450 Kuala Lumpur
Tel (603) 2032 2328 Facsimile (603) 2032 1328
