

HISAKA Holdings Ltd.

Return of the Transformers

*HISAKA Holdings Ltd.'s (HISAKA) strong results for 1H10 ended March 2010 suggests that it has already recovered fully from the crisis of 2009. We like HISAKA for its exposure to increased capital expenditure among semiconductor companies. In addition, we see HISAKA as an implementer of technology solutions given its strengths in automation and ventures into the clean energy and healthcare industries. **Initiate coverage with an intrinsic value of S\$0.440 (66% upside).***

Fundamental Drivers:

- As semiconductor companies feel the pinch from excessive capacity cutbacks in 2009, we believe that HISAKA is well poised to benefit from the up cycle in semiconductor CAPEX spending over the next three to four years.
- We are starting to see HISAKA grow its automation manufacturing business beyond the electronics industry. As the Singapore government continues to incentivize automation programmes to raise productivity, demand for HISAKA's solutions are likely to increase going forward.
- HISAKA's new businesses in 'Eco-friendly' products and medical equipment seem to be bearing fruit with new contracts announced in the last twelve months. With wider adoption, sales of these products are likely to increase going forward.

Outlook: As a result of its 1H10 performance and its development plans, HISAKA comes across as a convincing recovery story, which we believe will evolve to a growth play as revenue contribution from its new businesses kicks in. In addition, its strong balance sheet leaves plenty of room for acquisition and capacity expansion catalysts. The key upside risks against our projections is the introduction of new blockbuster products that will give revenue an unanticipated boost.

Increase Exposure

- Intrinsic Value S\$0.440
- Prev Closing S\$0.265

Main Activities

HISAKA Holdings Ltd. provides automation solutions with a focus on the sourcing and manufacturing of mechanical motion and mechatronics integration products.

Financial Highlights

(Y/E Sep) S\$m	FY08	FY09	FY10F
Revenue	56.3	34.2	73.1
Gross Profit	12.3	6.3	16.1
Earnings	3.9	0.7	8.0
EPS (S cts)	2.42	0.35	4.62

Source: Company, SIAS Research Estimate

Key ratios (FY10F)

PER	5.7
P/BV	1.2
ROE	21.2%
Debt/Equity	0%
Current ratio	3.7

Source: SIAS Research Estimate

Indexed Price Chart

Green (FSSTI)

White (HISAKA)



Source: Bloomberg

52wks High-Low S\$0.3069 /S\$0.1336*
 Number of Shares 172.8m
 Market Capitalization S\$45.8m
 *Fractional prices due to share buybacks

Analyst:

SIAS Research

admin@siasresearch.com

Tel: 6227 2107

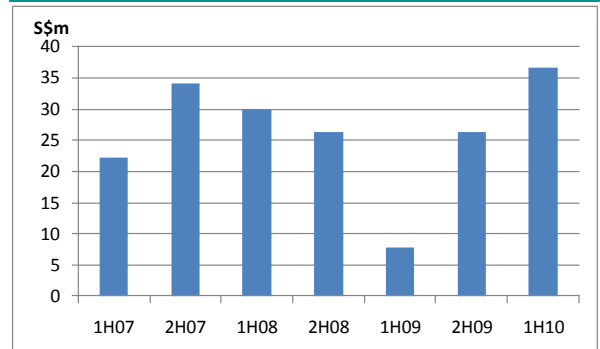
Introducing Mechatron(ics)

HISAKA Holdings Ltd (HISAKA) recently caught our attention following its impressive 1H10 performance where revenue rose by 38.7% QoQ and 368% YoY. Net profit grew 171% QoQ, reversing a loss of S\$873,000 over the same period last year. As a supplier of machine sets and parts to manufacturers, HISAKA will extend our research coverage to include capital equipment providers, having initiated on distributors and manufacturers in recent months. HISAKA is a complete provider of mechanical motion and automation products with an emergent business in producing renewable energy / energy saving products and medical equipment. The company has three main business divisions:

- a) Mechanical Motion Components Management
- b) Metallic Precision Manufacturing
- c) Mechatronics Integration

These three segments are complemented by the supply chain management services provided by HISAKA.

Figure 1: Half Yearly Revenue



HISAKA's top-line has fully recovered since the onset of the economic crisis.

Source: Company, SIAS Research Estimate

Figure 2: Key Products and Segments

Mechanical Motion Components Management (Services Segment)

- Distributes and sources for automation components such as mechanical motion products (e.g. linear motion tools and roller bearings) for clients.
- Unique characteristics: Some products have to be certified fit for use with the customer's machine and for the specified purpose. Depending on nature of use, specific requirements include heat resistance, clean room compliance, yield strength, surface consistency and low tolerance.



Metallic Precision Manufacturing (Manufacturing Segment)

- Customizes and fabricates non-standard parts.
- Processes include cutting, turning and grinding.



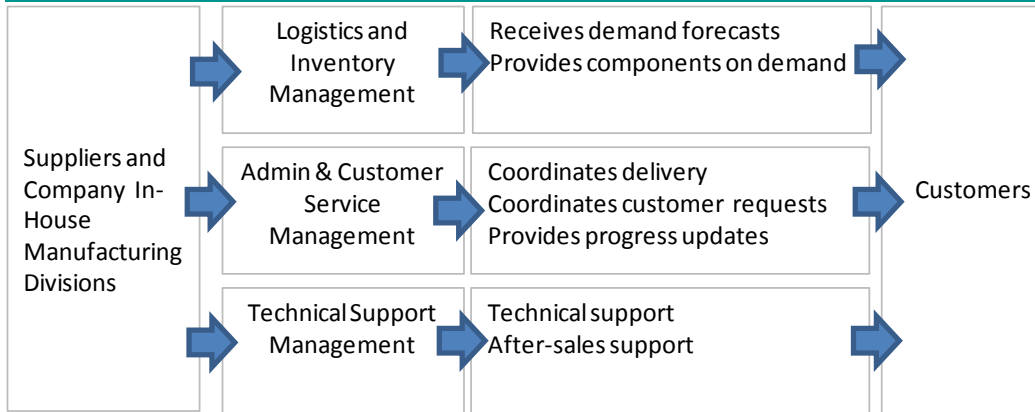
Mechatronics Integration (Manufacturing Segment)

- Recommends, designs and builds automation machines and lines.
- Combines precision mechanical components and motion control, e.g. load handling and guiding, to automate tasks.
- Products incorporate electrical, electronic and computer engineering for function control, data logging and human/machine communication, via graphical user interface. Hence, systems typically have an element of intelligence and programmability.

Above: A wafer transfer machine with ability to detect wafer condition before

Source: Company

Figure 3: Supply Chain Management Activities



Source: Company, SIAS Research Estimate

Value Propositions. HISAKA prides itself as a one-stop solution provider to customers that saves them considerable time in parts and equipment sourcing and technical maintenance, so that customers can focus on their core activities. In addition, HISAKA has the following advantages:

- It consolidates the product offerings of more than 300 suppliers, hastening the sourcing process.
- It is more cost effective to customize non-standard parts locally than to ship them back to the source supplier.
- It has recognized quality assurance standards that allow it to perform customization and integration work.
- It also modifies customer's OEM equipment to add on mechatronic capabilities, on top of commissioning completely new systems.
- Its close coordination with customers in supply chain management ensures that their production and processes will not be disrupted due to lack of parts.

We opine that HISAKA has positioned itself well between smaller single-service only (supply or design or manufacture) peers and larger companies who typically demand for high dollar orders, e.g. large scale multi-million dollar systems. Hence, HISAKA occupies the niche where companies only want to automate specific tasks and where the original equipment requires additional customization work that is not economical to be done by the OEM.

Figure 4: Supplied Products



Source: Company

Figure 5: A HISAKA System



A high-speed turret to test, mark, inspect and handle chips with PC interface

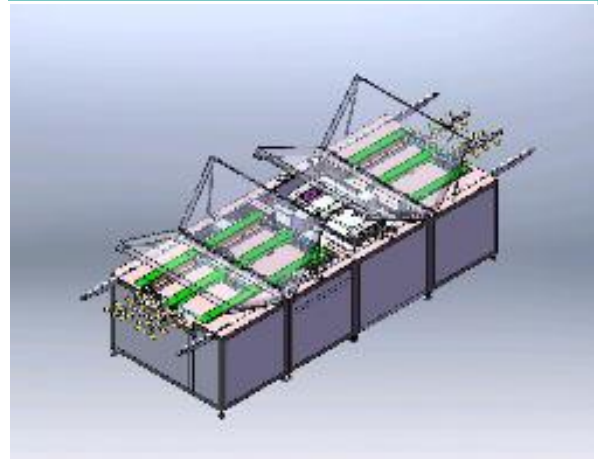
Source: Company

Growth Drivers. We believe that there are three growth areas that render HISAKA an attractive investment choice.

- a) A worldwide recovery in semiconductor and electronic manufacturing activity and capital equipment spending. More than 50% of HISAKA's revenue continues to stem from the semiconductor and electronic manufacturing services sectors.
- b) HISAKA's drive to bring and apply its automation solutions to other industries, such as medical, solar, wood, oil & gas companies.
- c) The development and commercialization of new products in the environment and medical equipment industries.

These growth opportunities are hinged on HISAKA's core competencies in sourcing, engineering and quality assurance. By focusing on selling its capabilities, we opine that these moves are astute measures aimed at breaking HISAKA's growth trajectory away from that of the electronics industry and setting the stage for exponential growth.

Figure 6: A HISAKA System (Solar Cell Manufacturing)



A system to clean the edges of solar panels via laser ablation with programmable logic controller and touch screen interface

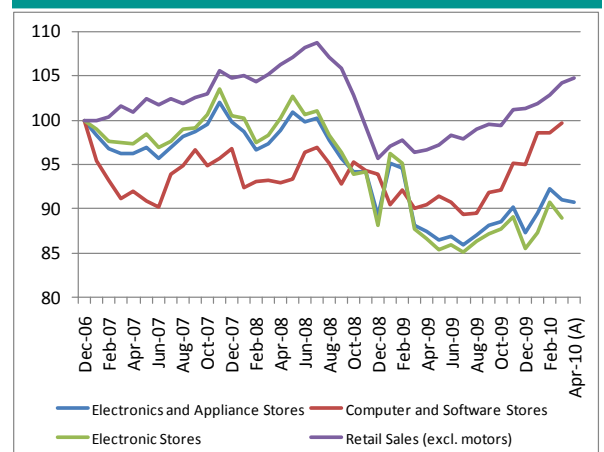
Source: Company

Rebuilding Cybertron

Demand for spares carried by HISAKA stems from both increased production activity which wears parts out faster, and higher capacity. On the other hand, sales of mechatronic modules will be driven by the equipment replacement cycle of companies. We are optimistic of HISAKA's prospects in its traditional industries of semiconductor and contract manufacturing as our research has shown that **we are at the beginning of a multi-year increase in capital investments among technology companies.**

- 1) **Demand for consumer electronic products to grow.** The US PC retail market's recovery has outpaced that of other electronic products in 2H09. We continue to anticipate strong demand for PCs going forward. Our view is further supported by Intel's positive outlook of low double digit growth over the next few years, to be driven by demand from servers, netbooks and 'smart' consumer electronic products.

Figure 7: US Retail Sales (Dec 06=100)



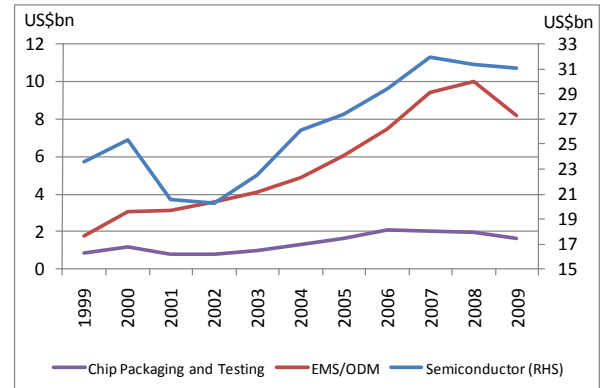
Source: US Census Bureau

2) In addition, we expect sales of larger ticket consumer electronic products such as TVs and home entertainment systems to accelerate in 2H10 and 2011 on rising purchasing power as income gains accumulate over time. In addition, they have longer replacement cycles and the recovery in their demand will naturally lag that of PCs by one to two years. Moreover, new products such as Blu-ray home entertainment systems, HD 3D TVs, smart TVs and touch screen devices will encourage discretionary purchases. As such, we maintain a positive outlook for memory and processor chips, spurring CAPEX in the industry.

3) **2009 CAPEX was unrealistically low.** Among the world's major manufacturing companies in the technology sector, CAPEX spending hit a high of 9.5% of revenue in 2004 before falling to 4.9% in 2009 led by a 7.8% fall in sales. Prior to 2005, CAPEX reached its lowest point in 2002 at 7.3%. Against the five-year average was 7.4%, CAPEX spending seems to have reached a cyclical and unsustainable low in 2009, leading to shortages and rising prices over the last twelve months. As such, CAPEX will most likely rebound in 2010, sustaining at >5% levels over the next three to four years. The peak-to-trough differential in capital spending over the last five years was the most evident among semiconductor companies at 6 percentage points.

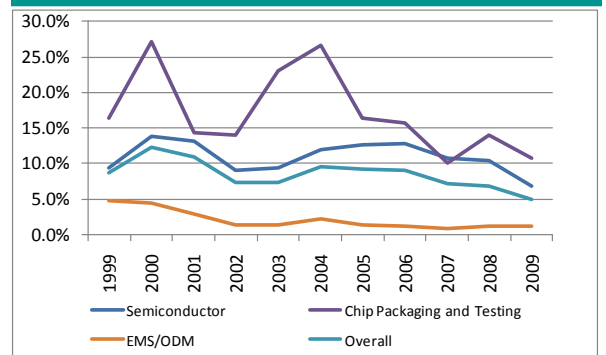
4) **Components shortages spur CAPEX.** To cut excess capacity, semiconductor companies have been closing down old foundries and slowing the buildup of new plants for some time now. When the financial crisis struck in late, they slashed spending even further. However, this left them unprepared for the sharp return in demand thereafter, leading to widespread DRAM shortages and price spikes. According to SICAS, global semiconductor capacity utilization reached a high of 89.4% in 4Q09.

Figure 8: Revenue of Top Computer and Electronic Manufacturing Companies



Source: Bloomberg, SIAS Research Estimate

Figure 9: CAPEX (% of revenue) of Top Computer and Electronic Manufacturing Companies



Source: Bloomberg, SIAS Research Estimate

Figures 8 and 9 are based on the financial data of

Semiconductors: Intel, Samsung, Toshiba, Texas Instruments, STMicroelectronics, Qualcomm, Hynix Semiconductor, Advanced Micro Devices, Renesas Electronics, Sony, TSMC, UMC and SMIC. EMS/ODM: Hon Hai Precision, Flextronics, Jabil Circuit, Sanmina-SCI, Celestica, Elcoteq, Benchmark Electronics, Venture, Universal Scientific Industries, Plexus, Quanta Computer, Asustek, Compal Electronics, Wistron, Inventec, Lite-on Technology, Mitac, Inventec Appliances, HTC Corp and Chimei Innolux Corp. Chip Packaging and Testing: Stats Chippac, Amkor Technology and ASE Global.

The components shortage in the technology industry is not restricted to memory chips. Years of high utilization lean manufacturing and a tight labour supply in parts of China, other components such as capacitors and connectors are also running low in inventory. While the current situation is expected to ease as the technology industry runs into its seasonal low past April, we believe that manufacturers can no longer put off expansion plans, in order to avoid a repeat of 2009/2010. As such, spending will not only increase in 2010 to match pre-crisis levels, but will also grow to make up for the 'lost' capacity of the last few years.

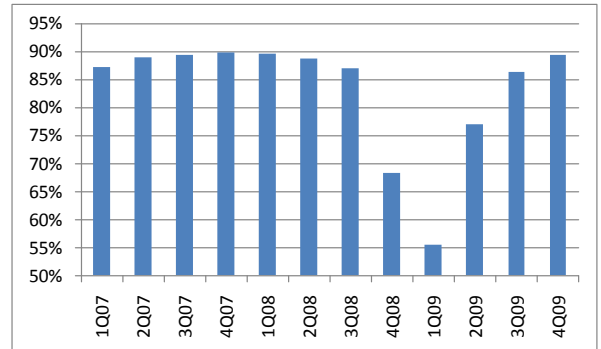
Given a combination of rising sales and pent-up equipment spending, more new plant and machinery are likely to come on line over the next two years. HISAKA stands to benefit from a long term increase in demand for parts with new facilities, on top of providing automation modules to the industry.

Finding HISAKA's All Spark

Mechatronics integration systems that HISAKA has built for its customers include:

- a) An integrated circuit socket measuring system (Figure 12A).
- b) A waste sorting system.
- c) An ultrasonic cleaner for machine components in the semiconductor industry.
- d) A graphite cutting machine (Figure 12B).
- e) A cartoning and palletizing line (Figure 12C).
- f) A fibre optic alignment system.
- g) A capillary tubes cutting machine (Figure 12D).

Figure 10: Semiconductor Capacity Utilization Rate



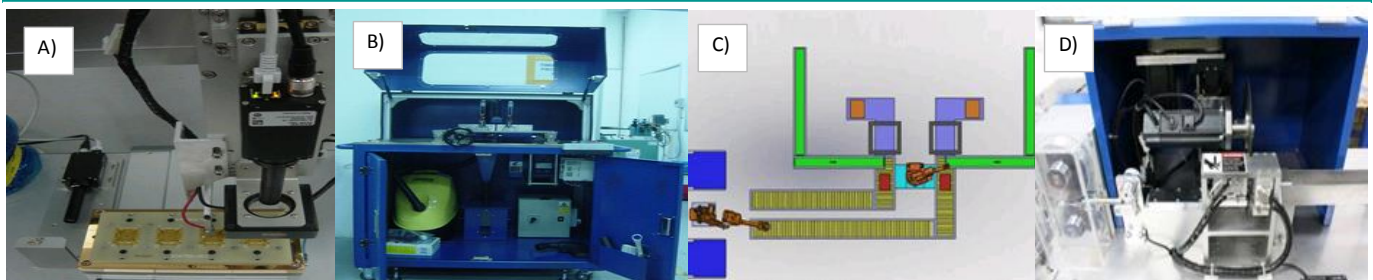
Source: Semiconductor International Capacity Statistics

Figure 11: DRAM Price Index (2005 – Present)



Source: DRAMeXchange, Bloomberg

Figure 12: Mechatronic Integration Systems Built



Source: Company

Building technological capabilities. HISAKA recently signed a memorandum of understanding with Ngee Ann Polytechnic to conduct feasibility studies, among other listed projects, to design or develop a single control box and graphical user interface for nano-precision machines. Since 2008, HISAKA has been pursuing technology in ultra-precision motion, micro manipulation solutions to expand its technological capabilities. HISAKA does not specifically have an R&D team, preferring to work with third party institutes to license or acquire the technology from them. However, HISAKA has a team of technicians and engineers to develop the acquired technology for commercial markets.

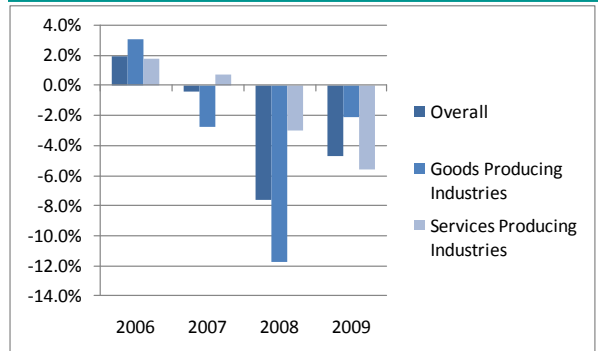
HISAKA's strategy allows it to expand its technological capabilities without engaging in lengthy and costly R&D activity from the exploratory stage. An expanded set of technological know-how in turn stretches the scope of automation solutions that it can provide to existing clients in the semiconductor and electronic manufacturing industries, miniature chips require extensive precision engineering.

Productivity solutions. We believe that there are opportunities for HISAKA to sell its mechatronics solutions to other industries. According to the Report of the Economic Strategies Committee of February 2010, Singapore's manufacturing and services sectors' productivity levels lag that of the US and Japan. The Committee cited examples from advanced economies where countries such as Finland and Australia have reinvented their manufacturing and construction industries via investments in more advanced production methods and the substitution of labour with technology.

To this end, the government has already implemented a number of measures.

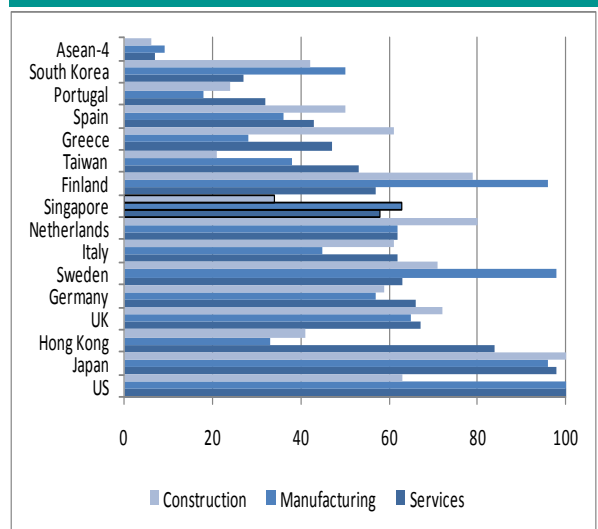
- a) Raise foreign worker levies to reduce low cost labour reliance.
- b) Implement the Productivity and Innovation Credit scheme where investments in automation equipment are given a deduction from taxable income at 250% of the first S\$300,000 of expenditure and 100% for the remaining balance. This effectively forms a tax rebate by the government for companies to invest in automation and productivity enhancements.
- c) Set up a S\$2bn National Productivity Fund to support initiatives, e.g. fund new equipment.

Figure 13: Singapore Labour Productivity (YoY)



Source: Singapore Department of Statistics

Figure 14: Cross Country Productivity Comparisons



Source: Report of the Economic Strategies Committee

In addition, the Committee recommended ‘a significant push to derive commercial value from R&D’ and to emphasize on business innovation. The intent is to raise productivity by tightening links between research institutions and the private sector so that there can be cross-fertilization of ideas and opportunities, where companies can market research output while research agencies will provide applied solutions for commercial problems.

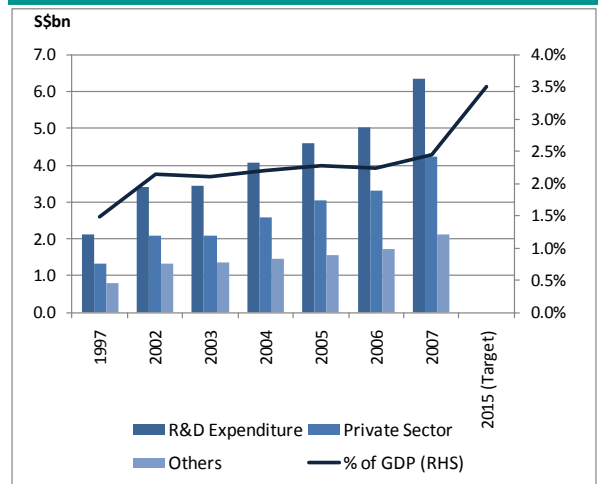
Automation equipment that qualify for tax deductions include automated chemical handling equipment, surface mount technology for automatic assembly of circuit boards, automated food processing machinery, semiconductor production machines and automatic photonics assembly. These are machines that we opine are within HISAKA’s technological capabilities.

We believe that companies can raise productivity by moving their products and services up the value chain and by automating their processes. The stage has already been set by the government for businesses to reengineer processes and increase productivity. We expect further incentives to be launched over time. HISAKA comes into the picture as an automation solutions provider.

Budding Developments

New businesses. To further monetize its technical expertise, HISAKA has recently entered the markets for renewable / energy saving products (Eco-friendly) and medical equipment products. Products include a green gas generator that can be used to replace oxy-acetylene industrial cutters. The green gas generator uses water and electricity instead of acetylene as the fuel. As such, its usage does not bear the risk of explosion and is more economical. Other items include a fluorescent tube that can elicit 35% to 50% savings as compared to conventional light tubes and a hybrid air conditioning system that runs on both solar energy and electricity. HISAKA’s green products are handled by its 60% owned subsidiary iEcopolis (Singapore) Pte Ltd. We noted from HISAKA’s product brochure that the green gas generator has already created a track record with shipyards and construction companies. In September last year, HISAKA also won a one year contract worth S\$8.7m to supply parts for ‘Eco’ communication devices to a manufacturer.

Figure 15: R&D Expenditure



Source: Singapore Department of Statistics

Figure 16: Green Gas Generator



Source: Company

HISAKA's medical products are generally used to assist diagnosis, treatment and monitoring of patients. They are typically portable devices that can be used in hospitals and in cross country terrain, such as disaster zones. Products include a portable blood warmer, ventilator and patient monitor. In July last year, HISAKA was awarded a S\$7m contract to supply and deliver medical equipment to a local customer. The contract runs from end June 2009 to June 2012.

We like how HISAKA has been receiving orders for its new businesses as it shows HISAKA's ability to bring to the market products of commercial value. In addition, HISAKA seems to have been working with external parties to develop these technologies and has prudently avoided the cost of failed research ventures. As these products are relatively new, we expect these businesses to contribute more significantly towards revenue only from 2011 onwards.

Financial Forecasts and Valuation

Based on HISAKA's moves in the industry, we see HISAKA as a bridge that brings technology to the market over time and are bullish on the company's prospects. The key risk against our view is its reliance on major customers, which will be mitigated over time as the company diversifies its revenue base. Another risk that we are concerned about is pricing pressure in the components supply business. However, higher margins in the manufacturing segment should be able to partially offset this risk.

Sound financial management. Instead of embarking on frivolous expansion plans, the company has spent about S\$2.3m to cancel 9m shares over 1H10 to increase shareholder returns. HISAKA chose to return excess cash to shareholders as it found manufacturing facilities in China too costly to acquire at the moment and had chosen to rent them. In addition, it also reduced its budget for acquisitions and joint ventures, owing to lower valuations of potential targets. If funds are needed for future expansions, HISAKA can choose to draw down on its stock of treasury shares currently worth about S\$5m at its last traded price of S\$0.265 each. As such, shareholders need not worry about funding issues going forward. In addition, the company does not have any bank borrowings at the moment. Shareholders also stand to enjoy a high dividend payout of 51% in FY08 and 278% in FY09.

Figure 17: Portable Blood Warmer System



Source: Company

Figure 18: Portable Patient Monitor



Source: Company

Forecasts and Valuation: We forecast revenue growth of 10% annually over FY11 and FY12, translating to an increase of S\$7.3m to S\$8.0m each year. We believe that our estimates are conservative as the revenue increments approximate the value of each new contract that HISAKA has announced over the last twelve months. A key upside risk to our forecast is the introduction of a blockbuster product, which we are unable to anticipate. We expect gross and net margins to stabilize at 22% and 10.9% respectively. As a result of HISAKA's buy back of shares and higher profits, FY10F return on average common equity (ROE) is projected to reach 21.2%, which we deem to be prudent given 1H10 annualized ROE of 23.5%.

Our intrinsic value of S\$0.440, based on a cost of equity of 12.11% and a terminal growth rate of 2%, implies a FY10F PER of 9.5X and a FY10F P/BV of 2.02X. Our valuation is unchallenging compared to its peers' current PER of 19.1X and P/BV of 1.03X. In the extreme case of 15% cost of equity and 1% terminal growth, we continue to arrive at a valuation of S\$0.337 which still carries an upside of 27.1% over its current price of S\$0.265. **Increase Exposure on intrinsic value of S\$0.440 (66% upside).**

Figure 19: Economic Profit Valuation Model

S\$m	FY10F	FY11F	FY12F
Revenue	73.1	80.5	88.5
EBIT	9.7	10.6	11.7
Tax on EBIT	-1.6	-1.8	-2.0
NOPLAT	8.0	8.8	9.7
Invested Capital	37.7	42.1	46.9
% of Debt	0	0	0
% of Equity	100%	100%	100%
WACC (%)	12.11%	12.11%	12.11%
Capital Charge	4.6	5.1	5.7
Economic Profit	3.4	3.7	4.0
Terminal Value			40.5
Discount Rate	0.94	0.84	0.75
Present Value	3.3	3.1	3.0
Book Value	35.9	Risk Free	2.47%
Explicit Value	9.4	Beta	1.195
Terminal Value	30.4	Market RP	8.07%
Value of Firm	75.7	Cost of Equity	12.11%
Number of Shares (m)	173	Cost of Debt	1.25%
Value per share (S\$)	0.440	LT Growth	2.00%

Source: SIAS Research Estimate

Figure 20: Financial Forecast and Estimate

	FY07	FY08	FY09	FY10F	FY11F	FY12F
Revenue	56.5	56.3	34.2	73.1	80.5	88.5
Gross Profit	13.0	12.3	6.3	16.1	17.7	19.5
Operating Profit	7.7	5.0	0.8	9.7	10.6	11.7
Net Profit	6.0	3.9	0.7	8.0	8.8	9.7
Attributable to Shareholders						
Total Current Assets	39.8	45.3	39.7	46.2	52.9	62.0
Total Non-Current Assets	4.0	4.4	4.6	4.1	4.1	4.1
Total Current Liabilities	20.0	9.1	6.4	12.6	14.9	19.2
Total Non-Current Liabilities	1.1	0.2	0.1	0.1	0.1	0.1
Total Equity	22.6	40.4	37.7	37.6	42.0	46.8
Cash from Operating Activities	0.67	6.16	1.16	6.00	3.48	11.30
Cash from Investing Activities	-0.11	-0.42	-0.07	-0.07	-0.53	-0.53
Cash from Financing Activities	-1.28	7.95	-3.53	-8.12	-4.39	-4.83
Net change in cash	-0.73	13.69	-2.44	-2.18	-1.44	5.94
Inventory Days	105	115	136	55	70	80
Receivable Days	106	108	161	100	115	115
Payable Days	142	104	94	60	80	90
ROE (%)	34.1%	12.5%	1.7%	21.2%	22.1%	21.8%
ROA (%)	15.8%	8.4%	1.4%	16.9%	16.4%	15.7%
Debt/Equity	13.1%	0.3%	0.1%	0.0%	0.0%	0.0%
Current Ratio	2.0	5.0	6.2	3.7	3.6	3.2
EPS (\$ cents)	4.40	2.42	0.35	4.62	5.08	5.59
BV/Share (\$ cents)	16.6	20.1	19.9	21.8	24.3	27.1
PER	6.0	11.0	75.7	5.7	5.2	4.7
P/BV	1.6	1.3	1.3	1.2	1.1	1.0

Source: SIAS Research Estimate

Figure 21: Sensitivity Analysis

		Cost of equity				
		11.0%	12.0%	13.0%	14.0%	15.0%
Terminal Growth	1.0%	0.474	0.426	0.385	0.351	0.321
	1.5%	0.486	0.434	0.392	0.356	0.325
	2.0%	0.499	0.444	0.398	0.360	0.328
	2.5%	0.514	0.454	0.406	0.366	0.332
	3.0%	0.530	0.466	0.414	0.372	0.336

Source: SIAS Research Estimate

Figure 22: Peer Comparison

	PER	P/BV	ROE	Operating Profit Margin
ARMSTRONG INDUSTRIAL CORP	9.3	1.87	15.8	10.9
BROADWAY INDUSTRIAL GRP LTD	6.2	1.15	17.3	6.7
ELEC & ELTEK INT CO LTD	7.0	1.08	12.9	11.6
HUAN HSIN HOLDINGS LTD	NA	0.42	-17.6	-5.9
INNOVALUES LTD	47.1	0.91	-7.4	-2.0
VENTURE CORP LTD	15.8	1.32	7.6	3.6
EUROPTRONIC GROUP LTD	NA	0.94	-56.5	-26.7
ISDN HOLDINGS LTD	28.8	0.58	2.0	5.2
AVERAGE	19.1	1.0	-3.2	0.4
HISAKA HOLDINGS	75.7	1.30	1.7	2.2

Source: Bloomberg, 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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