Long Ideas | Tech

Payton Planar Magnetics - Not Just Under The EV Hood, But Also A Play On Cloud Data Centers

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Summary

- Driven by the adoption of Planar Transformers in EVs, Cloud Switching and Aerospace, Payton reported strong 2018 numbers: 38% YoY growth, EBIT up 100%, 500bps GM% expansion YoY.
- While 2019 "hard" backlog may seem soft, it excludes the booming 2019-20 EV business and was ephemerally influenced by its biggest customer switching capacity from China to Taiwan.
- The disclosure of Payton's top customer (Quanta Computer) revealed that Payton sells massively into Hyperscalers Data Centers (e.g AWS/FB) and presumably the hyper growth AI section within.
- Payton is not only a play on the EV revolution but also a play on cloud data centers.
- Following the recent pullback, valuation is attractive (2018 P/E of 8 exc. cash) as the stock is driven by oblivious retail investors.

Since the publication of our "Top Idea" article on Payton Planar (**Payton Planar – A Hidden Gem Under the Electric Vehicle Hood)** the stock increased 60% at vibrant turnovers driven by blow-out H1/2018 results and the announcement of new $46M agreement with a tier-1 car parts manufacturer

Payton Planar (Euronext: PAY BB) (*no U.S. OTC ticker*) 5Y chart - red arrow indicates the top idea publication date



A few weeks ago, Payton published a strong 2018 report with solid YoY numbers:

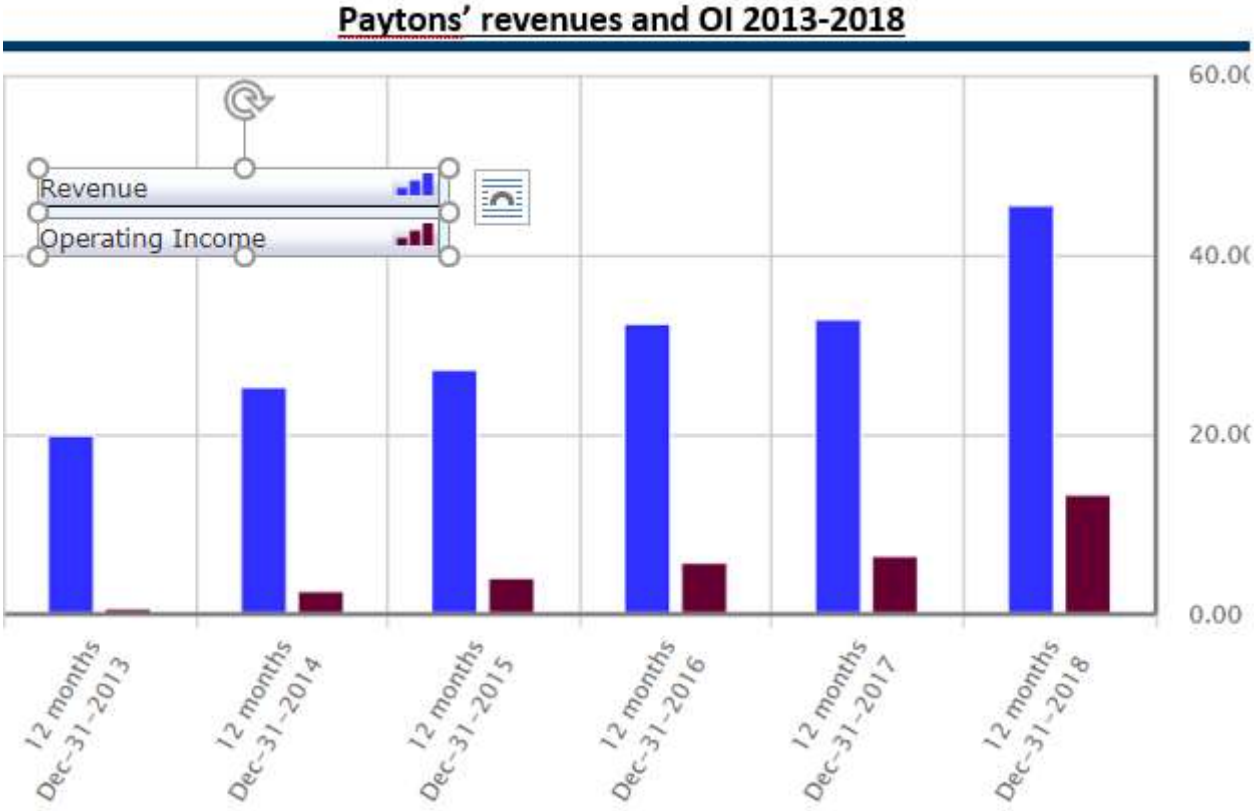
- Revenues grew 38% YoY
- Gross margins expanded YoY from 39.3% to 44.8%
- EBIT margins expanded YoY from 19.8% to 29.5%, EBIT doubled
- Net income more than doubled YoY from $5.5M to $11.4m
- The $46MEV framework agreement signed in Aug 2018 extended during Q1/19 to $74M

Payton Planar Magnetics Ltd.
Consolidated Comprehensive Income Statements

	Total 2018	Total 2017
Sales revenues	45,623	33,043
Cost of sales	25,192	20,064
Gross profit	*20,431*	*12,979*
Development costs	(1,335)	(1,240)
Selling & marketing expenses	(2,261)	(2,269)
General & administrative expenses	(3,403)	(2,948)
Other income (expenses), net	2	4
Operating income	*13,434*	*6,526*
Finance income, net	241	313
Share of profits of equity accounted investee	24	-
Profit before income taxes	*13,699*	*6,839*
Income taxes	(2,338)	(1,295)
Net profit for the year/period	*11,361*	*5,544*

Source: Payton's 2018 report, K USD

Overall, Payton continues to grow and increase its margin and profit, as it rides the shift toward more demanding electricity power supply in devices where heat, space, and weight are crucial.



Source: CapitalIQ

Recently, the market was disappointed over soft backlog numbers ($14.5M in 2019 vs $21M in 2018 as of March), which are probably driven by the temporary overall softness in cloud data centers in Q4/18 and Q1/19, as well Payton's biggest customer switching capacity from China to Taiwan due to trade tensions.

While other semi stocks recovered, Payton's did not (as it is still driven by oblivious retail investors). Payton's investors are missing 2 major points:

Point 1: Payton's EV business is booming. During Q1/19 its biggest automotive customer (Customer C) quadrupled its booking expectations for 2019-20.

On the surface, the backlog may seem soft, but most investors likely overlook the EV backlog intricacy. The company actually published that its EV framework agreement expanded from $46M to $74M and the 2019-20 backlog (under the framework agreement) quadrupled from Dec 31, 2018, to March 12, 2019, from $5M to $19M. Note the hard backlog number ($14.5M) excludes these $19M 2019-20 framework agreements with Customer C (automotive).

Payton's framework agreement with Customer C (Automotive)

Detailed below are the scope of the framework agreements the company is engaged, as of December 31, 2018 and March 12, 2019:

	December 31, 2018*	March 12, 2019*
	USD Millions	USD Millions
To be supplied in 2019	1	7
To be supplied in 2020	4	12
To be supplied in 2021	9	14
To be supplied in 2022 until 2025	32	41
Total	46	74

Source: Payton's 2018 report

The reason for the exclusion of these $19M from the formal binding "hard" backlog is because it's part of a long-term framework agreement that legally enables Customer C to cancel the order. Yet, the automotives lead times and design cycles make such a situation highly unlikely.

Hence the adjusted backlog is $14.5M + $7M = $21.5M

Note that Customer C who just engaged in the framework agreement in Aug 2018 has already increased its 2019 framework from $1M to $7M during the Q1/19, meaning the short-term cancellation risk is negligible.

Point 2: Payton has another growth engine – cloud data centers

Payton revealed in its report that its biggest customer is Tech-Front (Shanghai) Computer, a subsidiary of Quanta Cloud Technologies (QCT), which builds data centers for Hyeprscales (Facebook, AWS, Microsoft, etc.) It's also Nvidia's partner for its DGX data center architecture, which is based in Cloud Data Centers like FB Big Basin/Big Asur.

Note that unlike enterprises who buy servers and switches from OEMs like Dell, HP and Cisco, the Hyeprscales (AKA cloud providers like FB,AMZN,Goog,etc.) purchase directly from Taiwanese white label vendors, like Quanta.

Here are few industry articles about Quanta and its hyperscalers customers (FB/AWS/NVDA, etc)

Quanta sees data center demand from likes of Amazon, Google

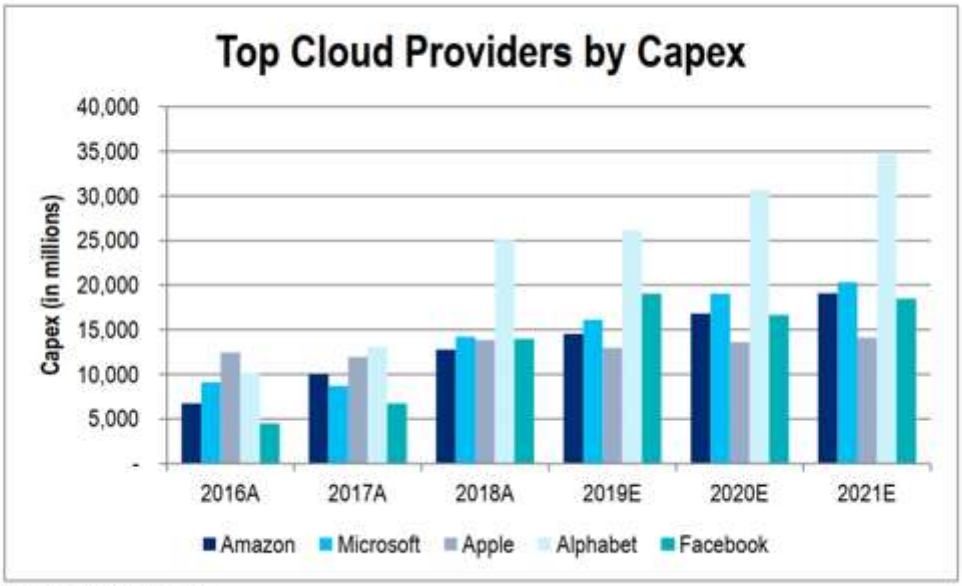
With Big Basin, Facebook Beefs Up its AI Hardware

How Facebook flipped the data center hardware market

While the CAPEX budget of the cloud providers was increased significantly during 2018, the industry took time to digest the huge capacity added in 2018.

Yet, that's only a temporary pause in the secular hunger of the cloud providers for more data-centers, as can be seen in the next graph

Figure 7. Top 5 Cloud Providers Capex



Source: FactSet, Company Reports, Citi Research

Source: Citibank's research on cloud capex, 2019

Indeed, Quanta reported it Q4/18 by late March 19', and during the conf call it stated that it

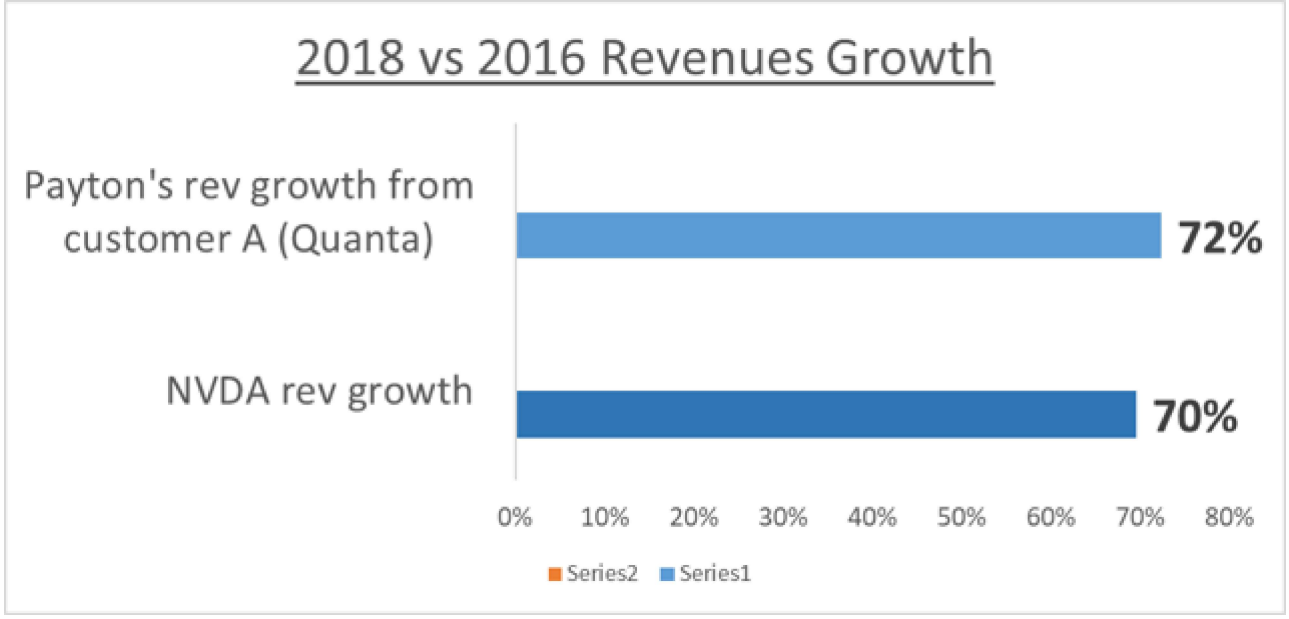
> *"targets double-digit cloud growth in FY19-21 on hyperscale data center/5G strength"*

And that's while the company expects slower 1Q19 momentum due to higher cost resulting from the server capacity switch (from China to Taiwan). However, Quanta is still positive on its 2019 outlook given organic server growth (mid double-digit YoY)"

As Deutsche Bank's analyst Frank Lin wrote on its Mar 27th note to clients following Quanta's report:

> *"The company believes its early mover advantage and technology strength in the telecom sector will help it delivera double-digit cloud revenue CAGR in FY19-21. We like Quanta's encouraging server/cloud outlook"*

Interestingly, the sales of Payton to Quanta Computer (its biggest customer) started to ramp up in 2016 and grew 72% from 2016 to 2018, which is very similar to the Nvidia sales pattern.



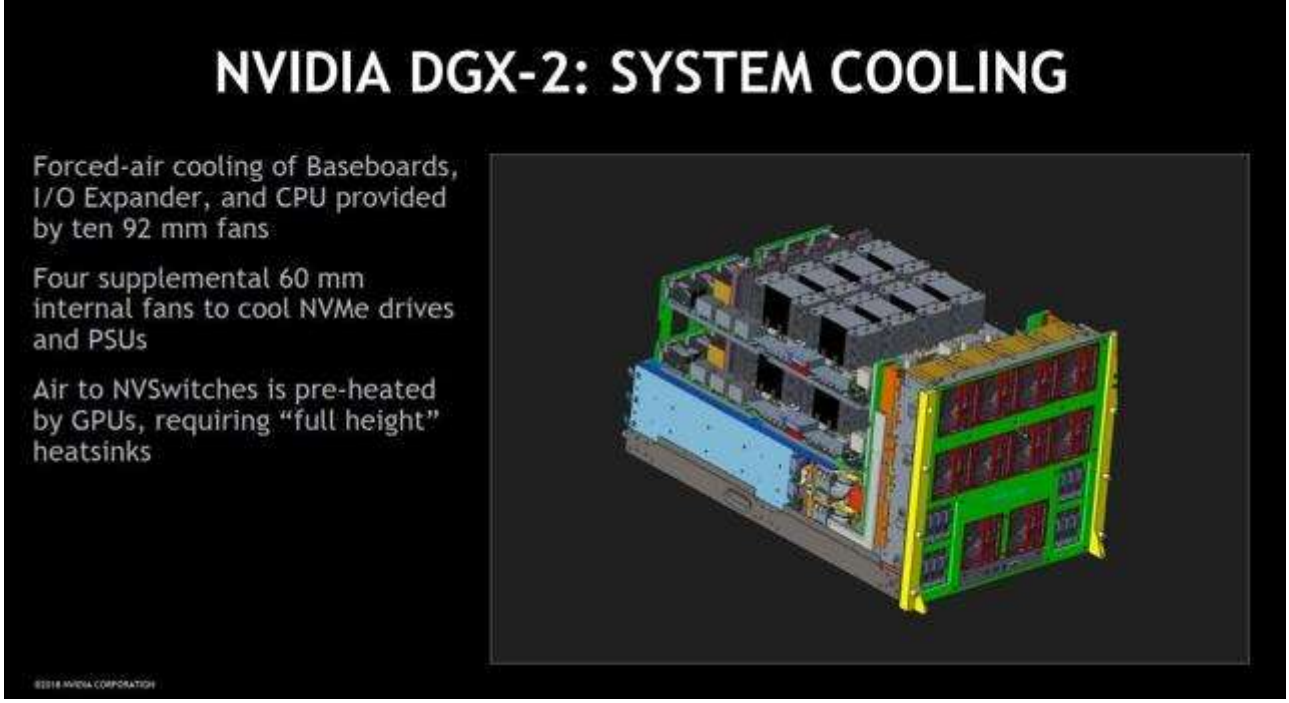
That corresponds to Nvidia's joint PR with Quanata

- NVIDIA Partners with World's Top Server Manufacturers to Advance AI Cloud Computing
- Quanta GPU Server Family to Support NVIDIA AI Ecosystem | NVIDIA Blog

As well as Nvidia's 2019 10-K:

> *We also utilize industry-leading contract manufacturers, or CMs, such as BYD and Hon Hai Precision Industry Co., and ODMs,* ***such as Quanta Computer*** *and Wistron Corporation, to manufacture some of our products for sale directly to end customers. In those cases, key elements such as GPU, SOC, and memory are often consigned by us to the CMs, who are responsible for the procurement of other components used in the production process"*

Needless to say, Nvidia's GPUs are monstrous power consumers. Therefore, heat is a major problem - not to mention power stability and consistency.



Source: Nvidia's Presentation

Since Nvidia had already alleviated concerns about inventory build-up during the last analyst day, which propelled the stock 30% higher YTD, we believe that Payton will resume its growth from its biggest customer in H2/2019 and especially 2020. That, on top of the quadruple EV backlog, may drive Payton into subsequent record years in 2020 and onward.

To sum up, 2019-21 seem to be pivotal years for the electric vehicle (EV) industry, as a flood of competitive and affordable EV models hit the roads, most of which have been introduced by legacy car manufacturers like GM, BMW, Volvo, and Renault-Nissan, among which you may find Payton's planar transformers.

The above models, as well as other non-Tesla EV models, will benefit from U. .sales, as buyers will be able to enjoy a full $7,500 federal tax credit for new electric-powered vehicles, as Tesla exhausted its 200,000 car quota as of last year.

Following 5 strong years, Payton is experiencing a bit of an ephemeral backlog softness that is likely due to technical reasons (switching capacity from China to Taiwan and capacity digestion of the cloud vendors and Nvidia), while its EV business continues to thrive.

Short-term investors may see the soft 2019 backlog as a glass half empty, but those who look under the hood will realize that the 2019 lemon may make great 2020-22 lemonade, as Payton continues to ride the massive build-up of cloud data centers, especially those based on AI.

Along with its prosperous EV business, the latest correction in Payton, brought the valuation to bargain ranges: 2018 P/E of 8 (exc. cash) and a 2020 P/E of 6.5 (exc cash), bearing in mind that Payton's income historically flowed fully to cash flow.

Payton 2012-2021 financial model

K USD	2012A	2013A	2014A	2015A	2016A	2017A	2018A	2019E	2020E	2021E	
Rev	17,601	20,021	25,327	27,372	32,354	33,043	45,623	47,106	56,527	65,006	Assuming Customer C framwork aggreement materializes and resumed growth of Cloud's data-
Growth YoY	-2.0%	13.7%	26.5%	8.1%	18.2%	2.1%	38.1%	3.3%	20.0%	15.0%	
Gross Profit	6,367	6,165	8,581	10,037	12,075	12,979	20,431	20,727	24,872	29,123	
Growth YoY	-24.1%	-3.2%	39.2%	17.0%	20.3%	7.5%	57.4%	1.4%	20.0%	17.1%	
GM %	36.2%	30.8%	33.9%	36.7%	37.3%	39.3%	44.8%	44.0%	44.0%	44.8%	Conservativley assumed that %GM won't improve, despite the historic trend as long runs drive %GM improvement
R&D Exp	846	913	939	949	1012	1240	1335	1554	1809	2080	
R&D of Rev %	4.8%	4.6%	3.7%	3.5%	3.1%	3.8%	2.9%	3.3%	3.2%	3.2%	
S &M	1,728	1,932	2,019	2,149	2,254	2,269	2261	3062	3844	4420	
S&M of Rev %	9.8%	9.6%	8.0%	7.9%	7.0%	6.9%	5.0%	6.5%	6.8%	6.8%	
G& A	2,325	2,804	2,979	2,850	2,959	2,948	3403	3533	4240	4745	
G&A of Rev %	13.2%	14.0%	11.8%	10.4%	9.1%	8.9%	7.5%	7.5%	7.5%	7.3%	
Other Income (expenses)	-5	-475	-15	8	-633	4	2	0	0	0	
EBIT	1,463	41	2,629	4,095	5,217	6,526	13,434	12,577	14,980	17,877	
Growth YoY	-54.6%	-97.2%	6312.2%	55.8%	27.4%	25.1%	105.9%	-6.4%	19.1%	19.3%	
Operating Margin %	8.3%	0.2%	10.4%	15.0%	16.1%	19.8%	29.4%	26.7%	26.5%	27.5%	
Interest income	581	261	131	160	190	357	392	450	450	450	Assumes 1.5% interest rate
Profit from minorities holding	0	0	0	0	0	0	24	26	28	30	
EBT	1,874	176	2,489	4,099	5,360	6,839	13,699	12,953	15,358	18,257	
TAX	-568	63	478	795	1,107	1,295	2,338	2,332	2,764	3,286	
TAX Rate %	-30.3%	35.8%	19.2%	19.4%	20.7%	18.9%	17.1%	18.0%	18.0%	18.0%	
Net Income	2,442	113	2,011	3,304	4,253	5,544	11,361	10,622	12,593	14,971	

Source: Lucid Captial's Analysis, Payton's reports

Payton may be a great opportunity for investors to cash in on both EV and cloud data centers in one stock with sound margins of safety.

This article was written by

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We are time travelers, disguised as tech investors. Our belief is that only when one truly fathoms industry, lucidity is formed. Unlike many asset managers who have financial backgrounds but lack in-depth tech & pr

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