Fabrinet:
Company Report and DCF Valuation

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Company History and Governance

Fabrinet was founded in 2000 as the dot-com era boomed and technology was moving forward at a breakneck pace. From the beginning, Fabrinet has been dedicated to developing and building a wide range of "precision optical components."[1] The firm primarily works with original equipment manufacturers (OEMs) and often uses the OEM's own equipment to create parts. Fabrinet handles everything else from labour to shipping to supply chain. Fabrinet operates many factories and locations all across Asia, although is based in the USA.

The founder of Fabrinet, David Mitchell, currently serves as the executive chairman on the board of governors. Mitchell previously founded Seagate Technologies, a hard drive giant in the technology industry. Overall, Mitchell has been involved in the technology industry since 1979.

New to Fabrinet in 2017, Seamus Grady serves as the CEO and sits on the board of directors. Before coming to Fabrinet, Grady was involved in Sanmina, a technology and medical tech manufacturer where he served in various executive capacities overseeing European operations, the PCB division, and EMS operations.

Every other executive at Fabrinet has background in the technology industry which is a big asset for Fabrinet when it comes to innovation and flexibility in an ever-changing market. Because of the experience in the sector, this executive team will be more open to change and may be able to grapple with new technologies sooner than the competition.

One deficit that is evident in their group is that only Toh-Seng Ng, the CFO and executive vice president has an MBA. While there are many business degrees in the mix, the valuable knowledge that comes with an MBA could be important for Fabrinet. During the coming years, as innovation slows relative to early 2000 levels, Fabrinet will have to look at ways to cut costs, be leaner, and anticipate market movements so they can position themselves well for the future. Because all of their business is contract-based, if they do not keep up with high technology and low-costs, they could easily be replaced by a competitor.

Industry Analysis and Positioning

Fabrinet occupies a space in the technology industry that will benefit from growth, but be protected somewhat from downturns. Because of their position as a contractor, and their use of the OEM's manufacturing equipment, they rely on the companies they deal with to do well for them to

[1] http://fabrinet.com/about/history

do well. As long as technology advances (which is inevitable) Fabrinet will have a business model. One area of risk for Fabrinet is their contractors. If they suddenly make bad business management choices and go under, Fabrinet may lose out on a lot of potential business. Fabrinet could also be exposed to negative public opinions of companies they deal with, although the bad press would not likely affect Fabrinet’s image, just its bottom line.

The technology industry may not always be the place of massive double-digit growth that it once was, but the steady march forwards means that in the lesser-known companies there is definitely room for undervalued firms. Firms such as Qualcomm, Micron, and NVidia typically take most of the headlines, leaving smaller firms to excel in the shadows. One analyst suggests that poor earnings reports from other technology manufacturers have investors holding their breath on all similar stocks.[2]

Competition and Comparables

While the technology sector is massive, Fabrinet definitely exists in a unique sector. They deal with optical components primarily, and do business on a contract basis. The main distinction from other tech companies is that they work mostly with high tech optics, and that is where the most comparable businesses could be found. In the end, two businesses stood out as good matches (Oclaro Inc. and Finisar Corp.) and two others were similar in that they were in the same industry and around the same size (Acacia and Lumentum).

In general, it appears that this selection of companies is undervalued by the market. With the exception of Lumentum, base case scenarios came in at least 15% over market value. The spread was obviously much greater for best case scenarios.

Company	Market Cap	PE	Average Value	Market
Oclaro	$999.96M	6.62	$69.07	$35.80
Finisar	$2,140.15M	10.58	$11.01	$7.77
Acacia	$1,387.03M	11.24	$22.58	$39.67
Lumentum	$2,797.64	-30.41	$3.56	$65.15

What one can see here is a generally low P/E across the comparables and a general under-valuation of the securities. This provides support for Fabrinet possibly being undervalued. It must be noted however, that when many companies in the same industry are undervalued, there could be resistance to breakthroughs or corrections. Such biases can mean that the value will not be realized by the market.

[2] https://seekingalpha.com/article/4060738-fabrinet-stock-break

Analyst’s Opinions

The average target price of analysts listed on FinViz[3] in the last year is approximately $50. These recommendations are from firms such as JP Morgan and Needham. These price targets represent what the “smart money” is forecasting. Again, we see support for a stock that is undervalued.

Wall Street Journal analysts seem to have a similar outlook on Fabrinet, with 5 of six rating the stock a buy for the two preceding months, and all 6 recommending a buy 3 months ago.[4] The price target established by these analysts is approximately $40, which is less than we saw from FinViz, but is still $15 higher than the current stock price.

DCF Valuation and Value Drivers

Value drivers were determined by looking at historical growth in revenue, operating margin, and sales to capital ratio. These were then referenced against the industry standards to come up with numbers that were realistic. The full base case DCF valuation can be found in appendix a.

The value drivers below:	Base Case	Best Case	Worst Case
Growth:	12.3752%	22.8690%	-2.1368%
Operating Margin in Year 10:	7.3114%	13.7448%	5.0605%
Sales to Capital ratio (start):	2.82	2.82	2.82
Sales to Capital ratio (end):	2.82	2.77	2.00

Fabrinet has seen increasingly positive revenue growth in the last 5 years, increasing from about 6% to 45% year over year. The base case growth of 12.375% is optimistic relative to the industry, but is still realistic. It recognizes that huge growth is not sustainable, and while the firm may still be growing, they are likely to slow down significantly.

The terminal-year operating margin is the same as the current operating margin, which is not much higher than industry average but is probable considering the contract-based, low-cost qualities of their business model.

[3] https://finviz.com/quote.ashx?t=FN
[4] http://quotes.wsj.com/FN/research-ratings

The year 10 sales to capital ratio is to remain the same as their current ratio. This is because historically they have grown, but stayed fairly close. The standard deviation of the ratio in the last 5 years has been around 0.50.

Base Case Scenario:	$49.63
Best Case Scenario:	$140.54
Worst Case Scenario:	$27.03
Market Value per Share:	$31.98

Recommendation

The overall recommendation for Fabrinet, taking into account comparables, industry averages, and the DCF valuation is buy. The stock appears to be undervalued. Target price is reasonably set at $50.

APPENDIX A – DCF Valuation Spreadsheet

	Base year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	Terminal year
Revenue growth%		12.38%	12.38%	12.38%	12.38%	12.38%	10.43%	8.48%	6.53%	4.59%	2.64%	2.64%
Revenues	$1,446	$1,625	$1,826	$2,052	$2,306	$2,591	$2,861	$3,104	$3,307	$3,458	$3,549	$3,643
Operating margin	7.32%	7.32%	7.32%	7.32%	7.32%	7.32%	7.31%	7.31%	7.31%	7.31%	7.31%	7.31%
EBIT (Operating income)	$105	$119	$134	$150	$169	$190	$209	$227	$242	$253	$260	$266
Tax rate	6.43%	6.43%	6.43%	6.43%	6.43%	6.43%	9.35%	12.26%	15.17%	18.09%	21.00%	21.00%
EBIT(1-t)	$98	$111	$125	$140	$158	$177	$190	$199	$205	$207	$205	$210
- Reinvestment	$12	$63	$71	$80	$90	$101	$96	$86	$72	$54	$32	$143
FCFF	$136	$48	$54	$60	$68	$76	$94	$113	$133	$153	$173	$68
Terminal Value											$1,501	

Cost of capital (WACC)		3.89%	3.89%	3.89%	3.89%	3.89%	4.54%	5.19%	5.84%	6.49%	7.14%	7.14%
Cumulated discount factor		0.9626	0.9266	0.8919	0.8585	0.8264	0.7905	0.7515	0.7100	0.6668	0.6223	
PV(FCFF)		$46	$50	$54	$58	$63	$74	$85	$95	$102	$1,0	

											42	

Implied variables												After year 10
Sales to capital ratio	2.82	2.82	2.82	2.82	2.82	2.82	2.82	2.82	2.82	2.82	2.82	
Invested capital	$512.26	$576	$647	$727	$817	$918	$1,014	$1,100	$1,172	$1,226	$1,258	
ROIC	19.14%	19.33%	19.33%	19.32%	19.32%	19.32%	18.71%	18.11%	17.50%	16.90%	16.30%	3.89%

Sum of PV(FCFF)	$1,669
Probability of failure =	0.00%
Proceeds if firm fails =	$834
Value of operating assets =	$1,669
- Debt	$68
+ Cash & MKt Securities	$263
Value of equity	$1,864
Number of shares	37.56
Estimated value /share	$49.63
Price	$26.42
Price as % of value	53.24%