4 June 2019

Industrials | Offshore & Marine

Sembcorp Marine (SMM SP)

Buy

O&M Pure Play; Reiterate BUY

Target Price (Return)	SGD1.99 (+43%)
Price:	SGD1.39
Market Cap:	USD2,4119m
Avg Daily Turnover (MYR/USD)	9.61m/2.3m

- **BUY with SGD1.99 TP, 43% upside.** Sembcorp Marine remains the only listed pure play in the Singapore offshore & marine sector that may experience a pick-up in activities. We expect its earnings base to increase significantly over 2019-2020, driven by savings in depreciation costs post yard consolidation, and a pick-up in orderbook replenishment. We value the stock at SGD1.99, based on FY20F P/BV of 1.8x, 1SD above its 5-year mean, on sector recovery.
- **Offshore contract flows to improve.** We expect orderbook replenishment to increase to SGD2.5-3.7bn on expectation of improving upstream activities globally. In particular, for FPSO conversion job awards, the number of projects sanctioned surged, starting in 2019 and largely in countries like Brazil and Africa. We expect LNG ship repair jobs to remain aplenty, with 41 LNG ships expected to be repaired and upgraded in 2019 (according to lngworldshipping.com). Repair and upgrade job margins are typically higher than fabrication jobs, with EBIT margins at 9-10% (vs 2-4% for fabrication).
- **Limited downside from Sete Brasil.** The group has taken SGD329m worth of provisions to account for the drillship contracts post the eruption of the Brazilian corruption scandal in 2015, and we believe that the provisions are sufficient based on current circumstances. Out of the seven drill ships contracted, we believe four have seen material work progress before the client stopped paying. In the event of any potential sale of the drill ships, write-backs of provisions would be a positive for the group.
- **Yard consolidation to reap benefits.** The group is left with two yards to be returned to the Singapore Government, with the bulk of operations to be directed to the integrated Tuas Boulevard Yard (TBY) and the group's corporate headquarters is expected to move there by 1H19. While the group could be hit with SGD60m worth of accelerated depreciation for 15 months starting 4Q19, it will realise cost savings of SGD48m pa starting FY20.
- **Paving the way for higher-end LNG jobs.** The group has gone on an acquisition spree for intellectual properties pertaining to LNG-related technologies, including the USD39m acquisition of Sevan Marine in Sep 2018. We have not imputed job wins from LNG-related projects in our orderbook replenishment assumption. Any future announcements of major LNG contracts could potentially result in positive adjustments to our base-case earnings.

Analyst

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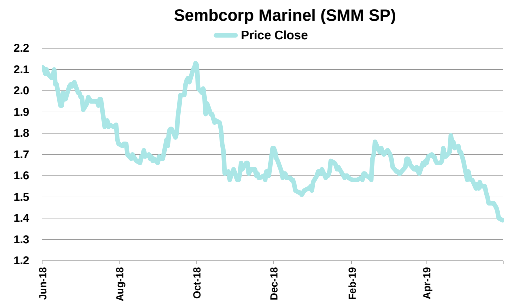
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(9.7)	(16.8)	(18.2)	(19.7)	(34.4)
Relative	(7.7)	(17.9)	(15.6)	(17.0)	(28.7)
52-wk Price low/high (MYR)					1.37 - 2.15



Source: Bloomberg

Forecasts and Valuation	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover (SGDm)	3,035	4,888	2,723	2,840	3,175
Net profit (SGDm)	198	(74)	9	55	62
Net profit growth (%)	89.1	(137.5)	(111.9)	526.0	13.1
Recurring EPS (SGD)	0.09	(0.04)	0.00	0.03	0.03
Recurring P/E (x)	15.4	(41.1)	346.1	55.3	48.9
P/B (x)	1.3	1.3	1.3	1.3	1.3
P/CF (x)	6.94	10.08	(35.96)	58.27	25.09
Dividend Yield (%)	2.6	-	-	-	-
EV/EBITDA (x)	12.8	49.6	34.8	21.3	20.1
ROAE (%)	8.0	(3.2)	0.4	2.3	2.5
Interest cover (x)	3.2	(0.5)	1.0	1.7	1.8

Source: Company data, RHB

Financial Exhibits

Asia
Singapore
Industrial
Sembcorp Marine Ltd
SMM SP
BUY

Valuation basis

P/BV

Key drivers

i. Stronger orderbook replenishment;
ii. Yard consolidation exercise.

Key risks

i. Margin compression in offshore contracts;
ii. Plunge in oil prices.

Company Profile

Operates shipyards in Singapore, Indonesia, United Kingdom and Brazil with capabilities covering rigs & floaters, repair and upgrades and offshore platforms.

Financial summary	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Recurring EPS (SGD)	0.09	(0.04)	0.00	0.03	0.03
DPS (SGD)	0.04	-	-	-	-
BVPS (SGD)	1.17	1.11	1.11	1.14	1.17
ROE (%)	7.97	(3.16)	0.37	2.28	2.52

Valuation metrics	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Recurring P/E (x)	14.7	(39.2)	329.6	52.6	46.5
P/B (x)	1.19	1.26	1.25	1.22	1.19
FCF Yield (%)	15.13	10.42	(2.92)	1.80	4.19
Dividend yield (%)	2.7	-	-	-	-
EV/EBITDA (x)	12.8	49.6	34.8	21.3	20.1
EV/EBIT (x)	20.8	(133.1)	77.3	42.7	40.1

Income statement (SGDm)	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover	3035	4888	2723	2840	3175
Gross profit	346	3	193	268	283
EBITDA (adj.)	499	140	203	329	342
Depreciation & amortisation	(193)	(193)	(111)	(165)	(170)
Operating profit	306	(52)	91	164	171
Net interest	(73)	(46)	(80)	(95)	(94)
Pre-tax profit	281	(101)	11	69	78
Taxation	(25)	23	(2)	(12)	(13)
Net profit	260	(74)	9	55	62
Recurring net profit	198	(74)	9	55	62

Cash flow (SGDm)	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Change in working capital	509	109	251	329	342
Cash flow from operations	843	685	115	252	322
Capex	(403)	(382)	(200)	(200)	(200)
Cash flow from investing	(403)	(382)	(200)	(200)	(200)
Dividends paid	-	-	-	-	-
Cash flow from financing	(340)	(354)	(447)	(60)	(135)
Cash at beginning of period	1,217	1,317	838	306	298
Net change in cash	100	(52)	(532)	(8)	(13)
Ending balance cash	1,317	838	306	298	285

Balance sheet (SGDm)	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total cash and equivalents	1,301	838	306	298	285
Tangible fixed assets	3,995	4,179	4,220	4,255	4,285
Total investments	68	67	67	67	67
Total assets	9,692	8,577	7,726	7,771	7,838
Short-term debt	1,252	1,136	1,242	1,222	1,178
Total long-term debt	2,563	2,325	2,541	2,501	2,410
Total liabilities	7,212	6,229	5,368	5,357	5,359
Total equity	2,480	2,348	2,358	2,414	2,479
Total liabilities & equity	9,692	8,577	7,726	7,771	7,838

Key metrics	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Revenue growth (%)	(14.4)	61.1	(44.3)	4.3	11.8
Recurrent EPS growth (%)	89.1	(137.5)	(111.9)	526.0	13.1
Gross margin (%)	11.4	0.1	7.1	9.4	8.9
Operating EBITDA margin (%)	16.4	2.9	7.4	11.6	10.8
Net profit margin (%)	6.5	(1.5)	0.3	1.9	2.0
Capex/sales (%)	13.3	7.8	7.3	7.0	6.3
Interest cover (x)	3.2	(0.5)	1.0	1.7	1.8

Source: Company data, RHB

Investment Highlights

Yard capacity management. As part of efforts to consolidate its operations**,** the group will continue to maximise utilisation at the integrated TBY, while reviewing the schedule for returning its older yards at or before the lease expiry dates. The group has two yards left to be returned after returning the Pulau Samulun yard to the Singapore Government. By 1H19, its corporate headquarters is scheduled to be moved to TBY. The group is scheduled to move out from Tanjong Kling yard completely by end-2019. The exercise is to move to TBY while returning the remaining yards. The group's yard count should drop to five from eight by the end of 2019, after the yard consolidation exercise.

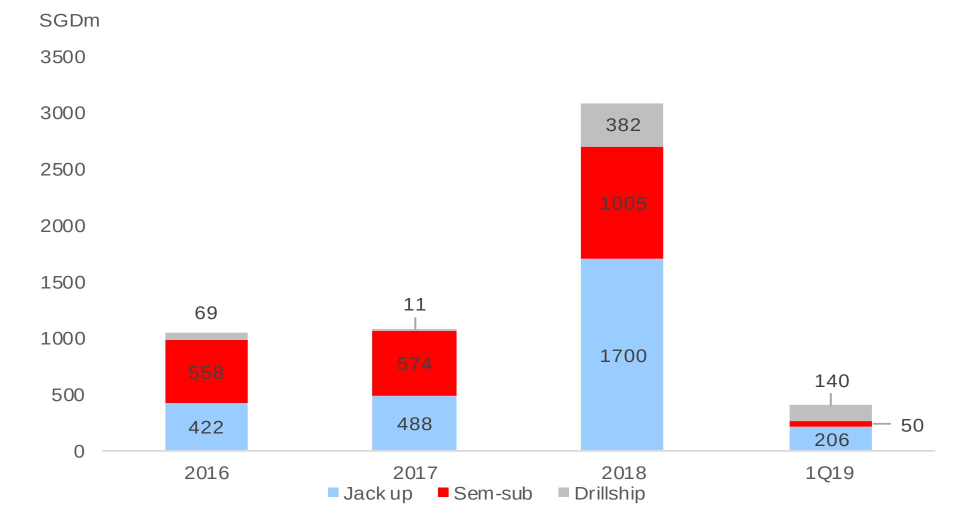
Benefits to be reaped from yard optimisation programme. The exercise will result in accelerated depreciation of the lease and certain fixed assets amounting to c.SGD60m over 15 months starting 4Q18, implying a SDG48m negative impact to the bottomline in FY19. However, starting FY20, the group will also be able to enjoy SGD48m in cost savings pa post the completion of yard capacity streamlining initiatives.

Working in a more streamlined fashion. Overall, with the integration of yard capacities in TBY, we believe Sembcorp Marine will be able to better focus on its offshore & marine (O&M) contracts while benefiting from cost optimisation in several areas of the yard operations (eg logistics costs). That aside, the bigger single yard space at TBY spanning 108 ha (vs the typical 80 ha or less per yard) also allows for bigger-sized projects involving higher contract values. In addition to lower depreciation costs, we have not imputed any operational cost savings from the yard consolidation exercise due to uncertain cost saving amounts. We also think that most of the cost savings would already be reflected in 2H19, with two yards to be returned to the Singapore Government.

Figure 1: Overview of Tuas Boulevard Yard

Source: Company

Figure 2: Breakdown of rig revenue



Source: Company data, RHB

Rig revenue driven by Borr Drilling purchase. In 2017 jack-up revenue was dominated by one rig delivery to Borr Drilling. In 2018, rig revenue increased threefold**,** primarily driven by seven jack-ups delivered to Borr Drilling during the year. In 1Q19, the last remaining rig was delivered to Borr Drilling, marking the end of the mega rig sale contract. To recap, the group had on 6 Oct 2017 signed an agreement for the sale of nine Pacific Class 400 jack up drilling rigs – including three rigs that were under various stages of completion post the termination of contract from previous clients – to Borr Drilling for an aggregate consideration of SGD1.8bn, to be delivered progressively from 4Q17 to 1Q19.

Legacy rig inventory cleared. Excluding potential interest and market fee payable in the event of a rise in jack-up rig market values, the transaction for the sale of nine rigs incurred total losses of SGD15m but it has removed concerns over the rig inventory overhang caused by premature termination by previous clients in the aftermath of the oil price downtrend since 2014. Moving forward, we expect rig revenue to trend lower in 2019, as the global rig market remains in a severe oversupply situation with rig inventories still high in the yards, particularly in China. Profitability should improve going forward, with the absence of contract losses from the Borr Drilling rig sale.

Higher semi-submersible (semi-sub) deliveries in 2019. The group delivered two semi-sub rigs in 2018 (CS60 semi-submersible rig – West Rigel – and Helix well-intervention semi-sub rig). For 2019, the group has three projects that are work in progress namely:

i. Heerema Offshore semi-sub crane vessel;

ii. 1st drillship for Transocean (JE III);

iii. 2nd drillship for Transocean (JE III).

While revenue could be lower YoY, profit contribution from semi-sub could be higher as the three rigs reach completion stage in 2019, with profit typically back-loaded towards the end of the contracts for rig builders.

Figure 3: Progress of Sete Brasil's drillship contracts since 2015

	Progress since 2015	Rig value (USDm)	Value of work in progress
1st	90%	800.0	720.0
2nd	80%	800.0	640.0
3rd	60%	800.0	480.0
4th	40%	800.0	320.0
5th	Undisclosed	800.0	NA
6th	Undisclosed	800.0	NA
7th	Undisclosed	800.0	NA
Total		5,600.0	2,160.0

Source: Company data, RHB

Sete Brasil's legacy issue nearing the end? Sembcorp Marine is stuck with legacy issues from Sete Brasil's drillship contracts, which hit a road bump during the 2015 Brazil corruption scandal that dragged Sete Brasil into financial difficulties. The group has already made SGD329m worth of provisions for the Sete Brasil contracts, which we believe is adequate under the current circumstances.

No further write-downs on Sete. We believe the rigs that are close to completion (80-90% completion) will potentially result in a reversal of provisions in the event the outstanding four rigs are included in the agreement being signed between Petrobras and Sete Brasil – the agreement details the new judicial recovery plan. In view of the recovery in oil prices and activities in the global upstream industry, we do not expect further write-downs for the Sete contracts moving forward.

Potential upside can also be realised if the group secures the sale of its partially completed rigs to other oil majors, or if Sete Brasil resumes payment for its work-in-progress drill ships amid the recovery in oil prices.

Orders for floaters to pick up. In 2018, three floater projects were delivered, namely FPSO Norte-Kaombo, FSO Alisa (for Modec), and FPSO Sul-Kaombo. Floater project deliveries should pick up in 2019, with six projects expected to be delivered – these are P68 FPSO, P71 FPSO and P68 hull (carried-over work for Petrobras), with the remaining jobs being Statoil Johan Castberg FPSO, Shell Vito FPU and Karish FPSO project. Based on the group's latest orderbook, floaters' share stood at SGD1.4bn, and we believe more replenishment will come from the floater segment given the perceived higher activity in the global FPSO market.

FPSO conversion to dominate headlines. In line with our expectation of a pick-up in FPSO conversion jobs up for grabs globally, we believe Sembcorp Marine's O&M division will see higher contract flows for FPSO conversion jobs in 2019. This will be supported by the high number of FPSO projects likely to be sanctioned particularly in Brazil and Africa over the next two years. With a strong track record in FPSO conversions, the group stands a high chance of winning a material portion of potential conversion orders during 2019-2020.

Repairs & upgrade division to stay strong. Sembcorp Marine emerged as the world's top LNG repair yard according to lngworldshipping.com, with a grand total of 41 LNG ships repaired and upgraded in 2018 alone. We believe this momentum will be sustained in 2019 due to new orders secured to-date, including USD150m of new orders secured for retrofitting ballast water treatment systems and/or gas scrubbers for 58 vessels. The group is also working on a contract with Varg LLC (wholly-owned by Teekay Offshore Partners) for the modification, repair and life extension of Petrojarl Varg FPSO that could be worth USD166m if finalised, further boosting its repairs & upgrades division.

Figure 4: First design-and-construction ship project for Norled AS

Source: Company data, RHB

Cruise ship business to provide extra boost. The group has also cemented itself in the Asian cruise ship repair and upgrade market, being among the best with 10 cruise vessels worked on in 2018. It also managed to worked with a new customer, Norwegian Cruise Line, in 2018, paving the way for more jobs from the cruise segment in future. The group has made further breakthroughs with new order secured for the construction and design of three battery-powered Ropax Ferries for Norled AS, one of Norway's largest ferry and express boat operators – these are built according to proprietary design from Sembcorp Marine, for delivery to the client by 4Q20.

Enhancing the business with intellectual property. The group acquired Sevan Marine together with its intellectual property in Sep 2018 for USD39m, which will expand its capabilities in cylindrical platform solutions for floating production and drilling.

Not just Sevan. In addition, the group has acquired several companies with intellectual assets and knowledge base during 2019:

i. **Sembmarine SSP** – design, engineering and construction of innovative floating production and drilling structures for the oil & gas industry;

ii. **LMG Marin** – ships, platforms, and floating structure design (including cruise ships);

iii. **Gravifloat** – designs and holds patents for a suite of marine LNG import or export terminals that are fixed near-shore, re-deployable, modular and scalable;

iv. **Aragon** – Specialises in front end engineering design (FEED) for FLNG and offshore structures.

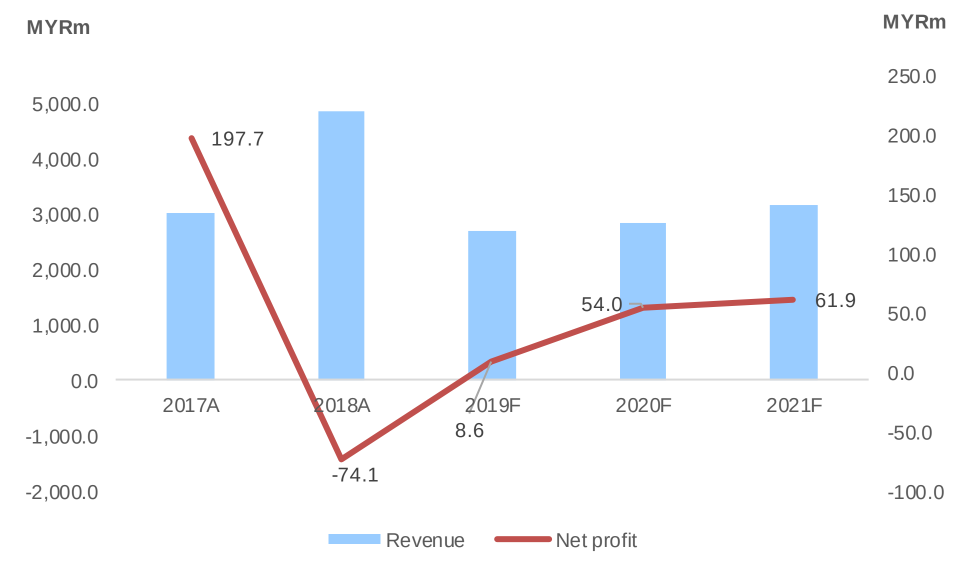
Figure 5: Illustration of Gravifloat's design of an LNG receiving terminal concept

Source: Company data, RHB

Potential upside from LNG contract replenishment. In our financial model, we have not imputed any new contracts from the acquired companies as we think the group is a relatively new entrant in the LNG structure fabrication and design space, and we anticipate significant contract wins only beyond 2020. Therefore, any significant contract wins involving LNG technology would further lift our valuation on the stock.

Forecasts & Valuation

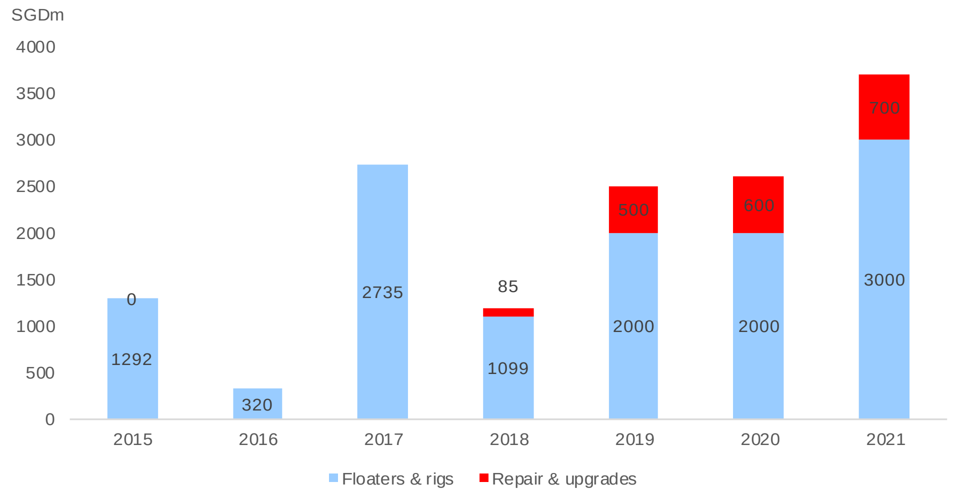
Figure 6: Actual & forecast revenue and net profit



Source: Company data, RHB

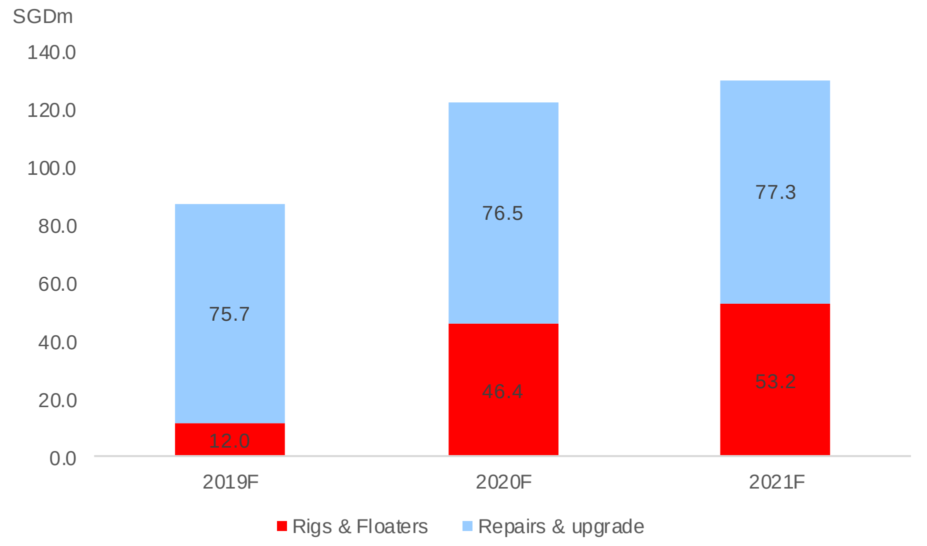
2019 to still be dragged by accelerated depreciation. We have assumed that the group will generate a slight profit of MYR8.6m in 2019 despite the inclusion of SGD48m for accelerated depreciation expenses post yard consolidation, which should be completed by end-2019. Whilst the revenue base is expected to be weaker YoY, we expect higher contributions from the more profitable ship repair division, which fetches higher EBIT margins. Offshore margins are expected to turn positive at 2% in 2019 (excluding non-cash accelerated depreciation) from losses the previous year from the sale of one semi-sub rig.

Figure 7: Orderbook replenishment



Source: Company data, RHB

Figure 8: Breakdown of EBIT forecasts



Source: Company data, RHB

FY20-21 earnings likely to see rebound. We expect the group to register a profit of MYR53.7m in FY20F before growing further to generate profit of MYR61.6m in FY21F, mainly underpinned by the following assumptions: -

i. Overall orderbook replenishment of SGD2.6bn and SGD3.7bn for FY20F and FY21F, based on expectations of a pick-up in offshore contract awards on stabilising oil prices and the expected rise in FPSO conversion job awards;

ii. Absence of SGD48m accelerated depreciation post completion of yard optimisation programme in 2019.

Our earnings forecast is conservative as the projected jump in profit from FY19 to FY20 is driven mostly by savings in depreciation costs (90% of the increase post yard consolidation completion) but before assuming a recovery in its core business in driving earnings growth in FY21.

Balance sheet. Net gearing is expected to decline gradually to 1.36x in FY21F from 1.47x in FY18 as capex is expected to normalise to SGD200m by FY21D from SGD382m in FY19. This is as it completes the yard consolidation exercise. With normalised capex, the group's balance sheet should not be under further strain as its operating cash flows are expected to grow to MYR322m by FY21F, in line with the projected improvement in margins and revenue.

BUY with TP of MYR1.99. We value the stock based on P/BV as its earnings are still in the early recovery stages, in line with the start of recovery in the oil and gas sector. Our TP of MYR1.99 is based on FY20F P/BV of 1.8x, or 1SD above its historical 5-year mean – we believe this is justified based on the following:

i. Recovery in the upstream market with stable oil prices;

ii. Earnings recovery for Sembcorp Marine post completion of its yard restructuring programme, with projected 2-year CAGR of 280.9% during FY19-21F;

iii. Perfect market positioning to benefit from potential rise in FPSO conversion jobs during 2019-2020, with orderbook replenishment expected to hit SGD1.4-1.5bn during FY19F-21F, higher than 2018's replenishment rate of SGD930m.

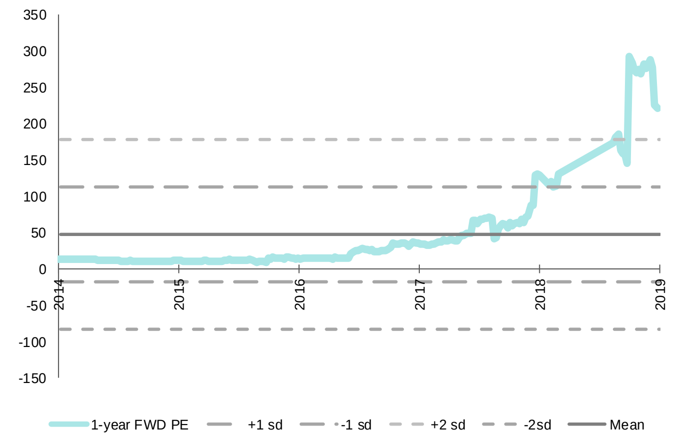
More rerating catalysts in the cards? In our opinion, the worst appears to be over for the group, while the bulk of its Sete Brasil-related work-in-progress inventories have been provided for. Any potential rise in demand or sale of the four rigs to other rig players would provide further upside potential if realised. In addition, any major LNG jobs secured by the group would result in a potential increase in our earnings estimates as we have not imputed any major LNG wins in our orderbook replenishment assumptions for the forecast period.

Figure 9: Peer comparison

Company	Call	Mkt cap	PER (x)		Earnings growth (%)		PBV (x)		ROE (%)		Div yield (%)	
		(SGD m)	19F	20F	19F	20F	19F	20F	19F	20F	19F	20F
Singapore												
KEPPEL CORP	NR	10,994	11.6	9.4	(5.7)	23.2	1.4	1.0	8.1	9.3	4.1	4.6
SEMBCORP MARINE	Buy	2,967	336.7	53.8	(111.9)	526.0	1.3	1.2	0.4	2.3	-	-
Korea												
HYUNDAI HEAVY	NR	9,470	NM	62.7	(10.5)	(241.8)	1.3	1.2	0.7	3.3	0.4	1.1
DAEWOO SHIPBUILDING	NR	3,714	NM	121.3	(123.7)	(125.5)	0.7	0.7	0.1	2.0	1.2	1.3
SAMSUNG HEAVY	NR	5,511	11.9	11.8	(16.3)	1.0	0.8	0.7	6.2	5.7	-	-
China												
YANGZIJIANG	NR	5,406	NM	62.1	(80.4)	(196.5)	0.7	0.7	(1.3)	1.5	-	-
CHINA SHIPBUILDING	NR	23,490	8.5	8.4	6.6	1.7	0.9	0.8	10.7	10.1	3.5	3.6
Malaysia												
MMHE	Sell	368	NM	NM	(24.5)	(54.3)	0.4	0.4	(3.9)	(1.8)	-	-
Simple average			**22.2**	**38.3**	**(45.8)**	**(8.3)**	**0.9**	**0.9**	**2.6**	**4.0**	**1.1**	**1.3**

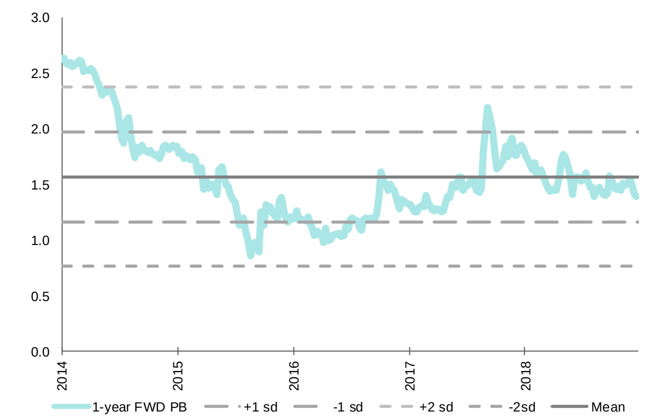
Source: Company data, RHB

Figure 10: SMM's P/E band



Source: Company data, RHB

Figure 11: SMM's P/BV band



Source: Company data, RHB

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Buy:	Share price may exceed 10% over the next 12 months
Trading Buy:	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain
Neutral:	Share price may fall within the range of +/- 10% over the next 12 months
Take Profit:	Target price has been attained. Look to accumulate at lower levels
Sell:	Share price may fall by more than 10% over the next 12 months
Not Rated:	Stock is not within regular research coverage

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