29 November 2019

Capital Goods | Aerospace & Defence

ST Engineering (STE SP)

Buy (Maintained)

Bullish On Earnings Outlook; Reiterate BUY

Target Price (Return)	SGD4.55 (+9%)
Price:	SGD4.17
Market Cap:	USD9,521
Avg Daily Turnover (SGD/USD)	17.9m/13.2m

- **Reiterate BUY, SGD4.55 TP implies 9% upside plus c.3.6% yield**. ST Engineering's (STE) double-digit profit growth outlook for 2020-2021, record-high orderbook with more than two years of revenue visibility, positive FCF-generation capability, reasonable dividend yield and ability to undertake earnings-accretive acquisitions led it to outperform the STI by 15% YTD. STE remains one of our Top Picks, with earnings contributions from the Newtec acquisition and continuing strong order wins as key re-rating catalysts**.**
- **New engine maintenance order win for Aerospace.** STE has secured a 15-year engine maintenance-by-the-hour contract from Japan Transocean Air (JTA). Under the agreement, STE will provide an integrated suite of engine maintenance, repair and overhaul (MRO) solutions that include off-wing maintenance support, on-wing services and technical support to JTA's Boeing 737NG fleet. These services will be provided over a period of 15 years from 2020 at STE's engine MRO facilities in Singapore. JTA, a subsidiary of Japan Airlines, operates 12 Boeing 737-800 aircraft, as per data from airfleets.net. STE's component engine repair & overhaul business accounted for 13% of its 2018 net profit.
- **Record-high orderbook.** With reported order wins worth SGD5.4bn in 9M19, STE has amassed an outstanding orderbook of SGD15.9bn, which is an all-time high. This orderbook provides revenue visibility of 2.5 years. We remain optimistic on STE delivering strong growth in 4Q19, as SGD2.2bn of the outstanding orderbook is expected to be delivered during the last quarter of 2019. STE reported a SGD1.8bn of revenue in 4Q18.
- **Small divestments; continues to optimise its business portfolio.** With an ongoing focus on optimising its business portfolio, STE divested small stakes in two entities during Nov 2019. It divested its pilot training business in Australia for SGD9.3m, at a gain of SGD1m. It also sold all of its 49% stake in Takata CPI Singapore (a JV company) for SGD5.3m, at a gain of SGD1m.
- **Contribution from acquisitions to drive near-term earnings.** STE has reported strong profit growth in the last two quarters, aided by contributions from Middle River Aerostructure Systems (MRAS), a US-based OEM engine nacelle manufacturer that it acquired early this year. We expect this profit contribution to increase, in line with the ramp-up in output at MRAS. We maintain that the recently-completed Newtec and Glowlink acquisitions should remain earnings-accretive, despite SGD20m in integration costs.
- **Key downside risks** include failure to sustain its current rate of strong order wins, an increase in MRAS & Newtec integration costs, and lower-than-estimated contributions from recently-completed acquisitions.

Forecasts and Valuations	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover (SGDm)	6,521	6,698	7,616	8,084	8,632
Recurring net profit (SGDm)	482	527	556	611	688
Recurring net profit growth (%)	(0.5)	9.2	5.4	10.0	12.5
Recurring P/E (x)	25.7	23.7	22.7	20.6	18.3
P/BV (x)	5.9	5.8	5.8	5.4	5.1
P/CF (x)	15.8	18.2	16.5	14.1	10.4
Dividend Yield (%)	3.6	3.6	3.6	3.6	4.0
EV/EBITDA (x)	17.7	16.4	15.2	13.4	12.0
ROE (%)	21.9	23.6	24.7	26.3	27.7
Net debt to equity (%)	5.3	3.6	84.3	76.9	59.3
Interest coverage (x)	12.7	12.7	13.8	9.5	10.7

Source: Company data, RHB

Analyst

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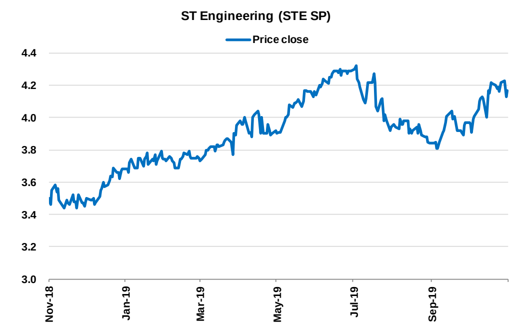
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	19.5	5.0	5.6	6.9	19.1
Relative	15.2	4.6	0.9	5.8	15.7
52-wk Price low/high (SGD)					3.42 - 4.35



Source: Bloomberg

Financial Exhibit

Singapore

Industrials

ST Engineering

STE SP Equity

Buy

Valuation basis

Our TP is derived by using an average of forward P/E, P/BV, EV/EBITDA and DCF of adjusted free cash flow.

Key drivers

i. Continued strong order wins;
ii. Earnings contribution from recently-completed MRAS and Newtec acquisitions

Key risks

i. Poor execution of diversification in the aerospace sector;
ii. Lower-than-estimated earnings contributions from recent acquisitions;
iii. Delay in the implementation of Singapore's smart nation initiative.

Company Profile

ST Engineering (STE) is an integrated engineering group in the aerospace, electronics, land systems and marine sectors. The company has, over the years, diversified its businesses and geographical coverage.

Financial summary	**Dec-17**	**Dec-18**	**Dec-19**	**Dec-20**	**Dec-21**
Recurring EPS (SGD)	0.16	0.18	0.18	0.20	0.23
DPS (SGD)	0.15	0.15	0.15	0.15	0.17
BVPS (SGD)	0.71	0.72	0.72	0.77	0.82
ROE (%)	21.9	23.6	24.7	26.3	27.7

Valuation metrics	**Dec-17**	**Dec-18**	**Dec-19**	**Dec-20**	**Dec-21**
Recurring P/E (x)	25.7	23.7	22.7	20.6	18.3
P/B (x)	5.9	5.8	5.8	5.4	5.1
FCF Yield (%)	23.3	33.9	25.3	20.0	13.2
Dividend yield (%)	3.6	3.6	3.6	3.6	4.0
EV/EBITDA (x)	17.7	16.4	15.2	13.4	12.0
EV/EBIT (x)	24.7	23.5	24.4	20.9	18.3

Income statement (SGDm)	**Dec-17**	**Dec-18**	**Dec-19**	**Dec-20**	**Dec-21**
Total turnover	6,521	6,698	7,616	8,084	8,632
Gross profit	1,313	1,406	1,585	1,745	1,903
EBITDA	760	814	997	1,130	1,238
Depreciation & amortisation	184	195	280	308	327
Operating profit	543	570	624	725	814
Net interest	(19)	(34)	(27)	(49)	(47)
Pre-tax profit	612	621	674	757	851
Taxation	(86)	(104)	(111)	(125)	(140)
Net profit	526	516	563	632	711
Recurring net profit	482	527	556	611	688

Cash flow (SGDm)	**Dec-17**	**Dec-18**	**Dec-19**	**Dec-20**	**Dec-21**
Change in working capital	2	(166)	(311)	(292)	(70)
Cash flow from operations	764	639	657	822	1,141
Capex	(271)	(332)	(274)	(275)	(270)
Cash flow from investing activities	(246)	(65)	(1,397)	(230)	(224)
Dividends paid	(468)	(468)	(468)	(463)	(520)
Cash flow from financing activities	(390)	(1,161)	1,062	(539)	(596)
Cash at beginning of period	904	998	414	739	792
Net change in cash	(643)	(1,200)	(321)	(748)	(797)
Ending balance cash	998	414	739	792	1,114

Balance Sheet (SGDm)	**Dec-17**	**Dec-18**	**Dec-19**	**Dec-20**	**Dec-21**
Total cash and equivalents	999	416	740	793	1,115
Tangible fixed assets	1,719	1,743	1,871	1,838	1,781
Total investments	-	-	-	-	-
Total assets	8,024	7,573	10,013	10,320	10,647
Short-term debt	222	225	-	-	-
Total long-term debt	894	270	2,635	2,635	2,635
Total liabilities	1,941	1,187	3,733	3,733	3,733
Total equity	2,215	2,246	2,249	2,397	2,565
Total liabilities & equity	8,024	7,573	10,013	10,320	10,647

Key metrics	**Dec-17**	**Dec-18**	**Dec-19**	**Dec-20**	**Dec-21**
Revenue growth (%)	(2.4)	2.7	13.7	6.1	6.8
Recurrent EPS growth (%)	6.7	8.3	26.1	15.4	11.1
Gross margin (%)	20.1	21.0	20.8	21.6	22.0
Operating EBITDA margin (%)	11.7	12.2	13.1	14.0	14.3
Net profit margin (%)	7.4	7.9	7.3	7.6	8.0
Capex/sales (%)	4.1	5.0	3.6	3.4	3.1
Interest cover (x)	12.7	12.7	13.8	9.5	10.7

Source: RHB, Company data

Figure 1: TP derivation

FYE Dec	x	Based on 2020 estimates
P/E-based valuation	22.00	4.31
P/BV-based valuation	5.80	4.45
EV/EBITDA-based valuation	11.00	4.48
DCF-based valuation		4.98
RHB's TP		**4.55**

Source: RHB

Figure 2: DCF valuation

FYE Quarter ended		Mar-19	Jun-19	Sep-19	Dec-19	2019 Dec-19	2020 Dec-20	2021 Dec-21	2022 Dec-22	2023 Dec-23
EBITDA	SGDm	217.3	254.1	262.1		997.4	1,130.3	1,238.0	1,303.1	1,371.6
Depreciation & amortisation	SGDm	(75.4)	(96.2)	(99.0)		(373.7)	(405.6)	(424.3)	(442.5)	(460.3)
EBIT	SGDm	141.9	157.9	163.1		623.7	724.7	813.7	860.6	911.3
Tax rate (%)	%	16%	17%	15%		16%	16%	16%	16%	16%
EBIT (1 - tax rate)	**SGDm**	**118.8**	**131.6**	**138.6**		**520.8**	**605.1**	**679.5**	**718.6**	**760.9**
Change in net working capital	SGDm	145.7	(170.0)	(262.7)		(311.1)	(291.9)	(70.1)	(58.5)	(63.1)
Net capex	SGDm	28.5	34.9	11.2		97.6	130.6	154.3	182.5	200.3
Free cash flow	**SGDm**	**293.0**	**(3.4)**	**(112.9)**		**307.4**	**443.8**	**763.6**	**842.6**	**898.2**
Terminal value	**SGDm**									**18,992.2**
Discount factor (nominal)	x	1.0	1.0	1.0		1.0	0.9	0.9	0.8	0.8
PV of nominal cash flow	**SGDm**	**293**	**(3)**	**(113)**		**307**	**417**	**676**	**701**	**15,575**
PV of cash flows	**SGDm**	**17,500.5**								
Cash	**SGDm**	760.9	3Q19							
Total debt	SGDm	2,435.4	3Q19							
Net debt / (net cash)	SGDm	1,674.5								
Minority interest	SGDm	270.7	3Q19							
Equity value	SGDm	15,555.4								
Shares outstanding (basic)	m	**3,122.5**	3Q19							
Equity value	**SGDm**	**4.98**								

Note: DCF value is adjusted for reported quarters
Source: RHB

Figure 3: DCF assumptions

Key assumptions	
beta	1.00
risk free rate	2.20%
market risk premium	4.50%
tax	17.50%
cost of debt	10.00%
cost of equity	3.00%
LT growth	6.70%
WACC used	1.50%

Source: RHB

Figure 4: DCF sensitivity analysis

Long term growth \ WACC	**5.3%**	**5.8%**	**6.3%**	**6.8%**	**7.3%**
0.5%	5.14	4.58	4.12	3.74	3.41
1.0%	5.73	5.06	4.51	4.06	3.68
1.5%	6.49	5.65	**4.98**	4.44	4.00
2.0%	7.47	6.39	5.56	4.91	4.37
2.5%	8.80	7.36	6.29	5.48	4.83

Source: RHB

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