

ST Engineering (STE SP)

2018 Investor Day takeaways

BUY

Share Price SGD 3.47
 12m Price Target SGD 4.15 (+20%)
 Previous Price Target SGD 4.15

Reinforcing our bullish view

STE held its first ever Investor Day for buy & sell side followers of the company - roughly an eight-hour affair with presentations from and interaction with top management of all business areas accompanied by a 117-page slide pack. Sifting through various strategy details, granularity & colour on operations and management's medium-term outlook, we highlight five guidance details that are new to us. Our positive outlook, forecasts, price target and BUY rating remain unchanged.

Five key guidance trends to be aware of

We highlighted the key reasons for our positive view on STE in our recent note '*Renaissance Revival*' 12 March 2018. Five details divulged during STE's 2018 Investor Day that reinforce this view are:

- **Smart City solutions revenue of cSGD1b to more than double by 2022:** Identified as a key growth driver over next five years. This is in line with our thinking but guidance is higher than our expected revenue growth of c55% for the whole Electronics cluster over FY17-FY22F.
- **Core businesses ex-Smart City revenue CAGR at 2x-3x global GDP growth rate (est. c3%) to 2022:** Broadly in line (albeit at low end) of our c6% revenue CAGR estimates.
- **Profits to grow in tandem with revenues:** We forecast profit growth at c10% CAGR over the FY17-FY22F period vs. revenue growth of c7% from our assumption of cost rationalisation gains.
- **Marine revenue to recover to FY13/FY14 levels by 2022:** This is far higher than our expectation; while we expect a stable outlook for Marine, our FY22 forecast is a material c40% lower than FY13 levels.
- **Efficiency measures to amount to cumulative net saving of SGD150m over five years and cSGD50m annually thereafter:** The long term savings gains are higher than our expected cSGD25-30m p.a. run-rate assumed.

Company Description

STE is an engineering conglomerate with business segments of Aerospace, Electronics, Land Systems, and Marine. It is also a major defence contractor.

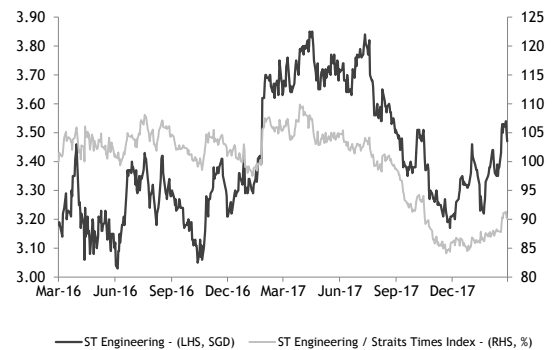
Statistics

52w high/low (SGD) 3.85/3.17
 3m avg turnover (USDm) 11.3
 Free float (%) 48.3
 Issued shares (m) 3,109
 Market capitalisation SGD10.8B
 USD8.2B

Major shareholders:

Temasek Holdings Pte Ltd. (Investment Co) 49.8%
 Aberdeen Asset Management (Asia) Ltd. 4.5%
 Capital Research & Management Co. (Globa) 2.8%

Price Performance



	-1M	-3M	-12M
Absolute (%)	3	8	(4)
Relative to index (%)	2	4	(15)

Source: FactSet

FYE Dec (SGD m)	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	6,684	6,619	7,030	7,555	8,091
EBITDA	718	770	903	1,042	1,141
Core net profit	550	528	565	656	724
Core EPS (cts)	17.6	16.9	18.1	21.0	23.2
Core EPS growth (%)	0.9	(4.0)	7.0	16.1	10.4
Net DPS (cts)	15.0	15.0	16.3	17.9	19.7
Core P/E (x)	19.7	20.5	19.2	16.5	15.0
P/BV (x)	4.4	4.3	4.2	4.0	3.9
Net dividend yield (%)	4.3	4.3	4.7	5.1	5.7
ROAE (%)	22.5	23.2	24.9	28.0	29.6
ROAA (%)	6.7	6.3	6.5	7.3	7.7
EV/EBITDA (x)	14.4	13.8	12.7	11.1	10.1
Net gearing (%) (incl perps)	0.2	5.2	14.0	15.2	12.9
Consensus net profit	-	-	559	591	633
MKE vs. Consensus (%)	-	-	1.1	11.0	14.5

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Forecasts, valuation and risks

We forecast a core profit CAGR of 11% for FY17-FY20F on the back of a revenue CAGR of 7% over the period. We expect this resumption to growth from five key factors:

1. The aerospace landscape has been improving since mid-2017, triggered by the rebound in global trade and better-than-expected passenger traffic growth;
2. The outlook for its electronics solutions remains robust and could hold an upside surprise with governments increasing investment in smart city infrastructure, i.e. smart street lighting, water management, metering, and cyber-security, etc.;
3. Rationalisation of problem areas in its Land Systems and Marine business is largely done and hence operating profit should have a lower drag from these units going forward;
4. Recent acquisitions, particularly SP Tel and Aethon are important additions to capabilities for tapping high growth in enterprise ICT, cyber security solutions and the autonomous robot market;
5. Greater integration across the business units as well as creation of new platforms to partner start-ups and fund technology gaps (initially seeded with USD150m) should enhance existing capabilities and materially speed up time-to-market for new solutions.

One other positive factor - although timing is hard to predict as contracts awards take long - is upside from an increase in US defence spending under the Trump administration. STE management is optimistic about defence exports growing in coming years (STE derives c20-25% of revenues from the US market).

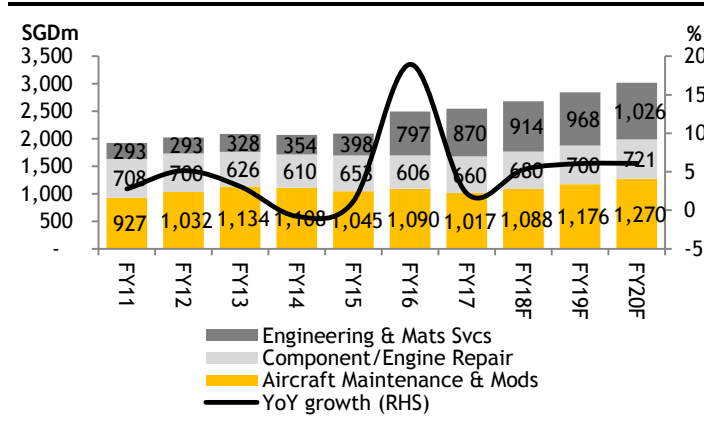
Our profit estimates for the three years are ahead of Bloomberg and FactSet aggregate consensus estimates by 1-15%.

Our price target of SGD4.15 is based on a discounted cashflow assuming 8.1% WACC, 2% TGR, and 20% ND/E.

The top-two risks to our forecasts are a material downturn in Aerospace and further write-offs in Marine. Other risks include a global macro downturn that results in cutbacks by governments in urban transport infrastructure and smart city investment and cost pressures arising from rising commodity prices and import tariff regimes in its operating markets.

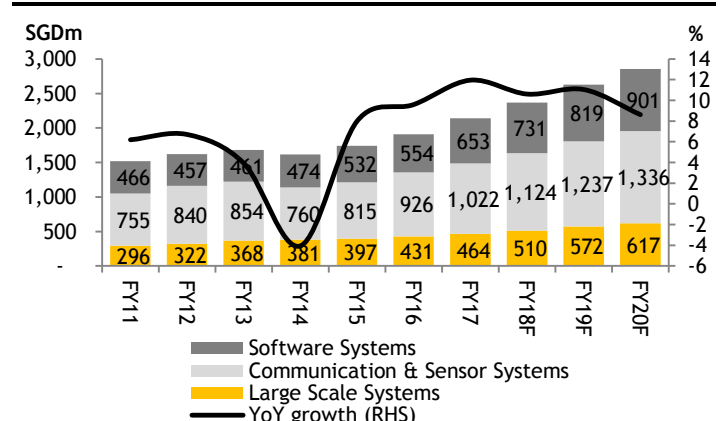
Key charts

Fig 1: Aerospace gross revenues



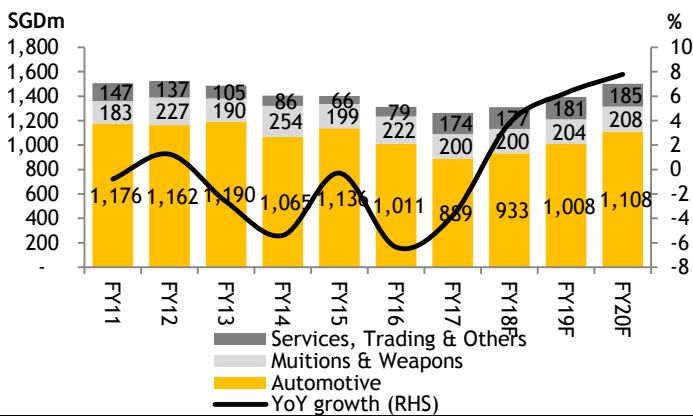
Source: Company, Maybank Kim Eng

Fig 2: Electronics gross revenues



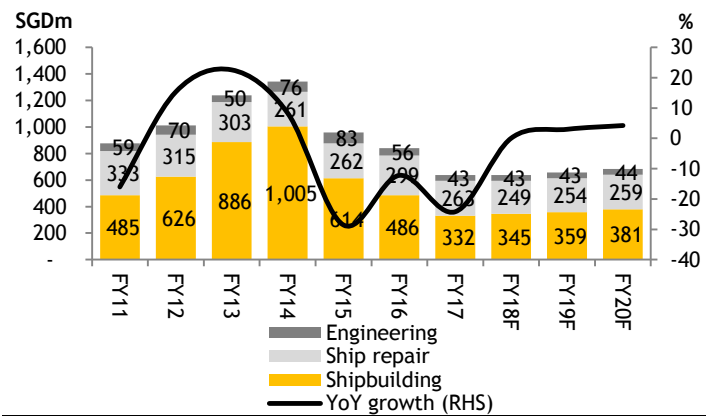
Source: Company, Maybank Kim Eng

Fig 3: Land Systems gross revenues



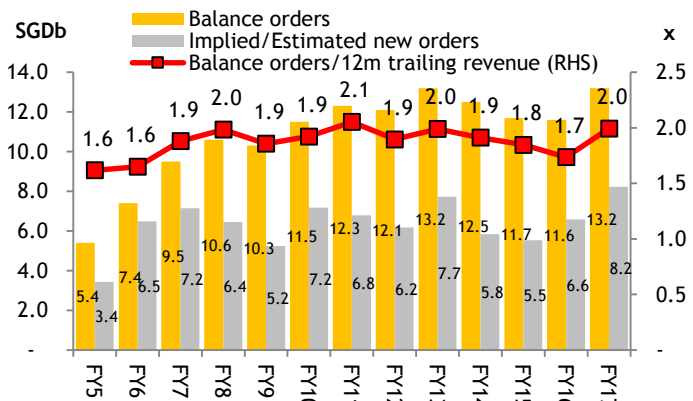
Source: Company, Maybank Kim Eng

Fig 4: Marine gross revenues



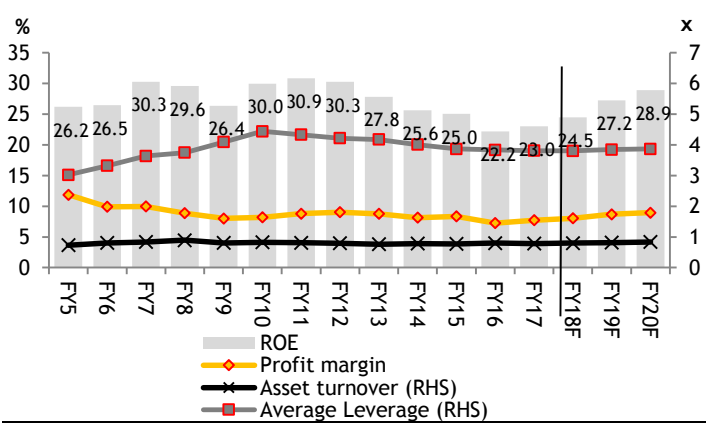
Source: Company, Maybank Kim Eng

Fig 5: Order book balance & estimated new orders*



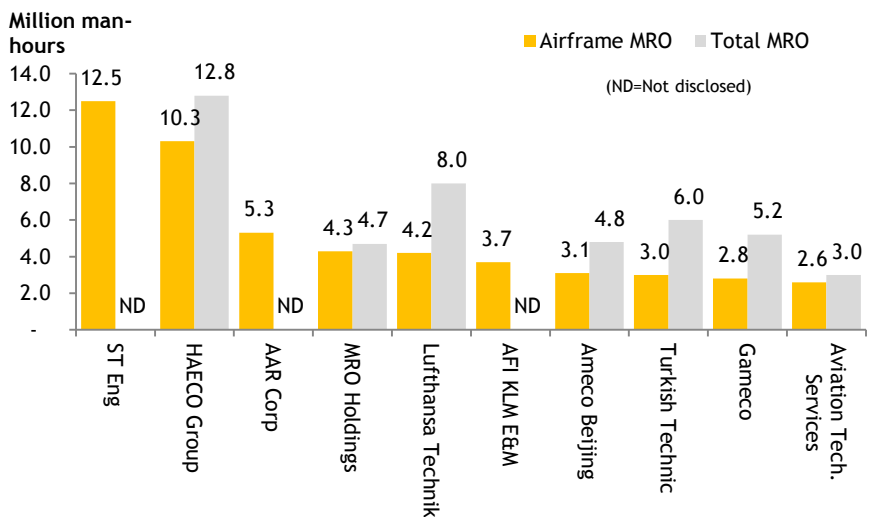
Source: Company, Maybank Kim Eng (*New orders: BOY order book - Revenue + New orders= EOY order book)

Fig 6: Du Pont ROE breakdown



Source: Company, Maybank Kim Eng

Fig 7: Global airframe MRO rankings

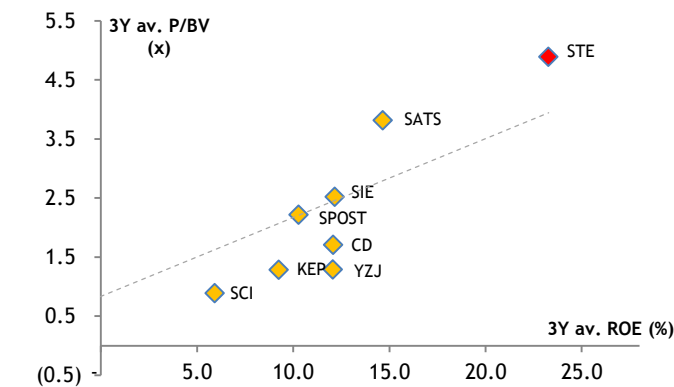


2017 Aviation Week Network biennial MRO survey

Value Proposition

- STE has a c50 year history as Singapore’s primary defence contractor. In the past couple of decades it has successfully evolved its operations to tap the commercial marketplace and presently the split between commercial and defence derived revenues stands at roughly 65:35.
- The company’s operating divisions are aligned by aerospace, electronics, land systems and marine sectors.
- The value proposition it offers customers is the ability to leverage on a deep pool of engineering expertise across multiple sectors to deliver tailored solutions.
- STE is also one of the largest aerospace maintenance, repair and overhaul (MRO) providers in the world and the largest independent one with a network of 18 centres.

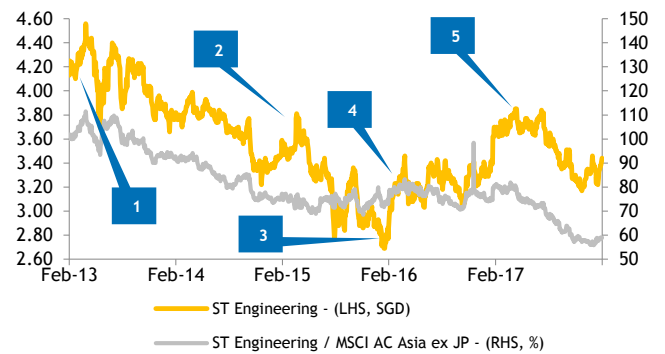
SG large-cap industrials historical P/BV vs. ROE



Source: FactSet

Price Drivers

Historical share price trend



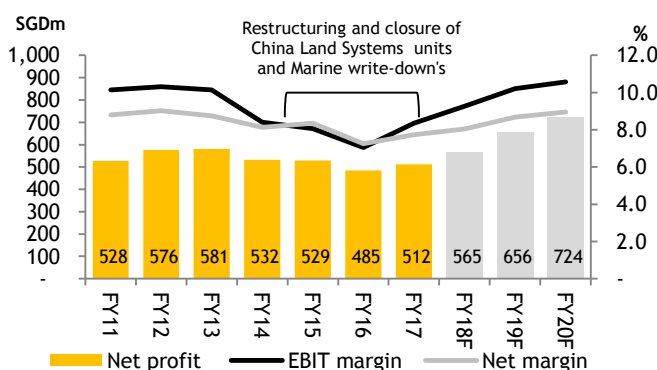
Source: Company, FactSet, Maybank Kim Eng

1. Substantial contract wins across business lines in 1H13 leading to one of the best contract win year’s post-GFC.
2. Guidance and growth outlook downgraded from demand slowdown and higher competition.
3. Multiple stock rating upgrades from the street.
4. Contract for refurbishment of five aircraft gets market excited about a turnaround in the Aerospace MRO sector - it hindsight this turns out to be a ‘false dawn’.
5. Large earnings miss by c18% versus consensus expectations with write-downs and restructuring costs. Management guidance muted.

Financial Metrics

- Two key factors drive our expectation of a blended margin recovery in FY18-FY20: growing higher-margin aerospace PTF contribution and a normalisation of margins in Land Systems and Marine post FY16/FY17 one-off charges.
- Aside from improving margins, Aerospace and Electronics order and revenue growth with a relatively stable Marine are the key factors underpinning our 11% FY17-FY20F core PATMI CAGR forecast.
- We expect ROE to rebound by c500bps to 29% levels by FY20, which also supports and sustains a re-rating of the stock.

PATMI growth and margin poised to recover



Source: Maybank Kim Eng, Company

Swing Factors

Upside

- Higher-than-expected PTF work from airlines upgrading their passenger fleets and cargo growth supportive. Better-than-expected margins if aircraft OEMs slow down their aftermarket expansion (as order books are full).
- A meaningful recovery in the marine business from a demand rebound for oilfield services vessels and specialised ship repair
- Order book growth from US defence and infrastructure project wins, an area that STE has been pursuing but large contracts have been elusive thus far.

Downside

- Intensifying price competition in aerospace driven by smaller players struggling with excess capacity.
- Structural threat from aircraft OEMs like Boeing and Airbus getting more aggressive in expanding in the aftermarket MRO space.
- Above-norm adverse currency moves and currency volatility against STE’s SGD reporting currency as a large segment of revenues are denominated in foreign currencies.

FYE 31 Dec	FY16A	FY17A	FY18E	FY19E	FY20E
Key Metrics					
P/E (reported) (x)	20.4	21.7	19.2	16.5	15.0
Core P/E (x)	19.7	20.5	19.2	16.5	15.0
P/BV (x)	4.4	4.3	4.2	4.0	3.9
P/NTA (x)	7.6	7.6	6.6	6.1	5.7
Net dividend yield (%)	4.3	4.3	4.7	5.1	5.7
FCF yield (%)	nm	nm	nm	nm	nm
EV/EBITDA (x)	14.4	13.8	12.7	11.1	10.1
EV/EBIT (x)	22.0	19.1	17.6	15.0	13.5

INCOME STATEMENT (SGD m)

Revenue	6,683.7	6,619.5	7,029.7	7,555.0	8,091.4
EBITDA	718.4	770.4	903.0	1,041.7	1,140.7
Depreciation	(195.7)	(183.6)	(218.4)	(236.8)	(252.6)
Amortisation	(51.6)	(33.3)	(33.3)	(33.3)	(33.3)
EBIT	471.1	553.4	651.3	771.5	854.8
Net interest income / (exp)	(12.0)	(18.0)	(29.3)	(38.6)	(40.1)
Associates & JV	63.8	49.3	55.3	58.6	62.1
Exceptionals	0.0	0.0	0.0	0.0	0.0
Other pretax income	67.8	38.7	39.7	40.7	41.8
Pretax profit	590.6	623.4	716.9	832.2	918.5
Income tax	(97.8)	(87.9)	(123.7)	(144.5)	(160.1)
Minorities	(8.3)	(23.5)	(28.3)	(31.7)	(34.1)
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	484.5	511.9	564.9	656.0	724.3
Core net profit	550.0	528.2	564.9	656.0	724.3
Preferred Dividends	0.0	0.0	0.0	0.0	0.0

BALANCE SHEET (SGD m)

Cash & Short Term Investments	1,093.8	999.4	963.0	1,034.9	1,108.4
Accounts receivable	1,820.8	1,960.5	2,214.8	2,380.4	2,549.3
Inventory	1,898.3	1,764.3	1,829.6	1,966.4	2,106.0
Reinsurance assets	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equip (net)	1,670.1	1,719.4	1,851.9	1,966.1	2,014.3
Intangible assets	1,019.6	1,087.4	954.1	920.7	887.4
Investment in Associates & JVs	405.5	448.4	470.5	493.9	518.7
Other assets	456.9	494.0	494.0	494.0	494.0
Total assets	8,365.1	8,473.4	8,777.9	9,256.4	9,678.2
ST interest bearing debt	87.4	221.6	264.9	288.9	294.3
Accounts payable	1,750.9	1,716.6	1,846.4	1,962.9	2,094.7
LT interest bearing debt	1,012.3	910.0	1,059.6	1,155.4	1,177.2
Other liabilities	3,070.0	3,104.0	3,024.0	3,161.0	3,308.0
Total Liabilities	5,920.9	5,952.0	6,194.4	6,568.1	6,874.4
Shareholders Equity	2,182.3	2,240.0	2,296.5	2,394.9	2,503.5
Minority Interest	261.9	281.4	287.1	293.4	300.2
Total shareholder equity	2,444.2	2,521.4	2,583.5	2,688.3	2,803.7
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Total liabilities and equity	8,365.1	8,473.4	8,777.9	9,256.4	9,678.2

CASH FLOW (SGD m)

Pretax profit	590.6	623.4	716.9	832.2	918.5
Depreciation & amortisation	247.3	217.0	251.7	270.1	285.9
Adj net interest (income)/exp	12.0	18.0	29.3	38.6	40.1
Change in working capital	104.0	(38.3)	(305.9)	(69.2)	(45.0)
Cash taxes paid	(179.5)	(76.5)	(87.9)	(123.7)	(144.5)
Other operating cash flow	(29.7)	15.7	(44.7)	(48.8)	(52.1)
Cash flow from operations	742.8	758.7	558.5	898.3	1,002.0
Capex	(248.6)	(272.6)	(350.0)	(350.0)	(300.0)
Free cash flow	401.1	324.6	308.5	548.3	702.0
Dividends paid	(468.4)	(468.4)	(508.4)	(557.6)	(615.6)
Equity raised / (purchased)	0.0	0.0	0.0	0.0	0.0
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Change in Debt	(105.1)	31.9	192.9	119.8	27.2
Perpetual securities distribution	0.0	0.0	0.0	0.0	0.0
Other invest/financing cash flow	38.6	(144.0)	70.7	(38.6)	(40.1)
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Net cash flow	(40.7)	(94.4)	(36.4)	72.0	73.5

FYE 31 Dec	FY16A	FY17A	FY18E	FY19E	FY20E
Key Ratios					
Growth ratios (%)					
Revenue growth	5.5	(1.0)	6.2	7.5	7.1
EBITDA growth	3.0	7.2	17.2	15.4	9.5
EBIT growth	(7.7)	17.5	17.7	18.5	10.8
Pretax growth	(6.3)	5.5	15.0	16.1	10.4
Reported net profit growth	(8.4)	5.7	10.3	16.1	10.4
Core net profit growth	0.9	(4.0)	7.0	16.1	10.4
Profitability ratios (%)					
EBITDA margin	10.7	11.6	12.8	13.8	14.1
EBIT margin	7.0	8.4	9.3	10.2	10.6
Pretax profit margin	8.8	9.4	10.2	11.0	11.4
Payout ratio	96.7	91.5	90.0	85.0	85.0
DuPont analysis					
Net profit margin (%)	7.2	7.7	8.0	8.7	9.0
Revenue/Assets (x)	0.8	0.8	0.8	0.8	0.8
Assets/Equity (x)	3.8	3.8	3.8	3.9	3.9
ROAE (%)	22.5	23.2	24.9	28.0	29.6
ROAA (%)	6.7	6.3	6.5	7.3	7.7
Liquidity & Efficiency					
Cash conversion cycle	107.7	109.5	107.9	109.1	110.1
Days receivable outstanding	95.2	102.8	106.9	109.5	109.7
Days inventory outstanding	130.5	124.5	115.4	114.1	114.5
Days payables outstanding	118.1	117.8	114.4	114.5	114.1
Dividend cover (x)	1.0	1.1	1.1	1.2	1.2
Current ratio (x)	1.3	1.2	1.3	1.3	1.3
Leverage & Expense Analysis					
Asset/Liability (x)	1.4	1.4	1.4	1.4	1.4
Net gearing (%) (incl perps)	0.2	5.2	14.0	15.2	12.9
Net gearing (%) (excl. perps)	0.2	5.2	14.0	15.2	12.9
Net interest cover (x)	39.2	30.7	22.2	20.0	21.3
Debt/EBITDA (x)	1.5	1.5	1.5	1.4	1.3
Capex/revenue (%)	3.7	4.1	5.0	4.6	3.7
Net debt/ (net cash)	5.9	132.2	361.5	409.3	363.1

Source: Company; Maybank

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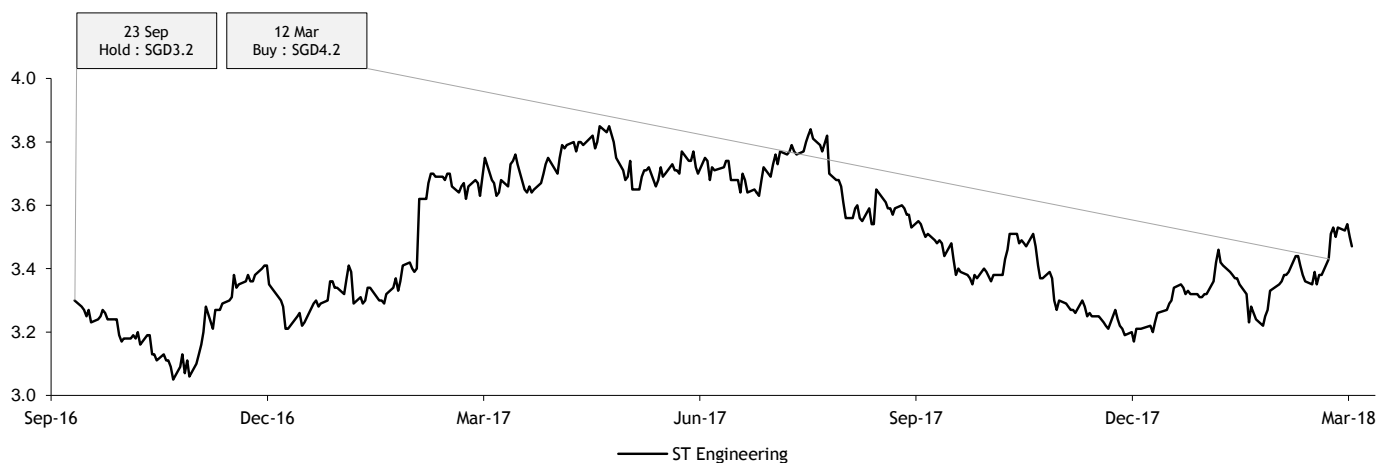
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