SIA Engineering

Bloomberg: SIE SP | Reuters: SIAE.SI

Refer to important disclosures at the end of this report

DBS Group Research . Equity

3 Nov 2015

HOLD

Last Traded Price: S$3.93 (**STI :** 2,974.41)
Price Target : S$3.84 (-2% downside) (Prev S$3.52)

Reason for Report : 2Q16 results
Potential Catalyst: Recovery in engine MRO cycle, M&A activity
Where we differ: Earnings estimates largely in line with consensus

Analyst
Suvro SARKAR +65 6682 3720 suvro@dbs.com

Result Summary

FY Mar (S$m)	2Q 2016	2Q 2015	1Q 2016	yoy % chg	qoq % chg
P&L Items					
Turnover	266	285	277	(6.7)	(4.1)
Gross Profit	27.0	15.9	20.9	69.8	29.2
Opg Profit	27.0	15.9	20.9	69.8	29.2
EBITDA	56.5	55.4	55.6	2.0	1.6
Net Profit	44.5	42.1	41.3	5.7	7.7
Other Data					
Gross Margin (%)	10.2	5.6	7.5		
Opg Margin (%)	10.2	5.6	7.5		
Net Margin (%)	16.7	14.8	14.9		

Financial Summary

FY Mar (S$m)	2014A	2015A	2016F	2017F
Revenue	1,178	1,121	1,120	1,121
Operating Profit	24.3	23.1	20.9	27.0
EBITDA	315	233	231	235
Net Pft (Pre Ex.)	265	177	177	181
EPS (S cts)	23.8	16.3	15.7	16.0
EPS Pre Ex. (S cts)	23.8	15.8	15.7	16.0
EPS Gth (%)	(2)	(31)	(4)	2
EPS Gth Pre Ex (%)	(3)	(33)	(1)	2
Net DPS (S cts)	25.0	14.5	14.0	14.0
BV Per Share (S cts)	122	118	120	123
PE (X)	16.5	24.0	25.0	24.6
PE Pre Ex. (X)	16.5	24.8	25.0	24.6
EV/EBITDA (X)	12.4	17.2	17.4	17.2
Net Div Yield (%)	6.4	3.7	3.6	3.6
P/Book Value (X)	3.2	3.3	3.3	3.2
Net Debt/Equity (X)	CASH	CASH	CASH	CASH
ROAE (%)	20.0	13.6	13.2	13.1

At A Glance

Issued Capital (m shrs)	1,123
Mkt. Cap (Sm/USm)	4,414 / 3,159
3m Avg. Daily Val (US$m)	0.82

ICB Industry : Industrials
ICB Sector: Industrial Transportation
Principal Business: Leading regional aircraft maintenance, repair and overhaul (MRO) company with bases in Singapore and Philippines. A comprehensive cluster of JVs with renowned OEMs allows it to provide a full suite of MRO services.
Source: Company, DBS Bank, Bloomberg Finance L.P.

Core operating margin improves

- **2Q16 net profit of S$44.5m in line with expectations**
- **Operating profit margin normalised to 10% in 2Q16 on the back of lower subcontracting costs**
- **However, contributions from engine repair shops remained weak; JV/ associate income down 41% y-o-y so far in 1H16**
- **6Scts interim dividend declared; maintain HOLD with higher TP of S$3.84**

Highlights

Lower costs drive the 6% increase in 2Q16 earnings. SIAEC recorded lower operating expenses of S$239m in 2QFY16, driven by a y-o-y reduction in staff costs, materials and subcontract costs by 5%, 12% and 27% respectively. Material costs declined in tandem with lower revenue, while lower subcontract costs primarily represent a normalisation trend, as FY15 saw an above-average proportion of work that SIAEC did not have capabilities for, therefore pushing up subcontracting costs. Net profit thus improved by 6% y-o-y in 2QFY16 on the back of lower costs, even as revenues fell.

Heavy maintenance segment a drag on revenue. Group revenues were down 4% q-o-q and 7% y-o-y in 2QFY16, as weakness in the heavy maintenance section persisted due to lower work content and longer check intervals on newer aircraft types. On a half-year basis, both fleet management and line maintenance recorded slight upticks in revenues, helped by additional aircrafts under the fleet management programme and an increase of handled flights at Changi Airport by about 2%. However, these gains were offset by the decline in heavy maintenance revenues of 16% in 1HFY16, causing the Group's 1H16 revenue to decrease by 6% y-o-y.

JVs and associates still feeling the pinch. New generation engines, which have had their maintenance cycles extended from 4-5 years to about 6 years currently, have continued to contribute to declining shop visits at the engine JV/Associates such as SAESL and Eagle Services Asia, causing a 41% slump in profits from these entities y-o-y in 1H16, and a 28% decline in overall profits from JVs and Associates in 1H16. Management expects the new engine cycle to pick up again only in a year to a year-and-a-half's time.

Outlook

Major headwinds still persist. The heavy maintenance segment faces an uphill battle. Newer aircraft are seeing their maintenance cycles being lengthened, on top of needing less maintenance by virtue of just being new. Furthermore, we see narrow-body aircraft leading the growth in air traffic in Asia, whereas SIA Engineering's core expertise and customer base in heavy maintenance lie in wide-body aircraft servicing, owing to the fleet profile of parent SIA. Engine shops should continue to dampen the earnings contribution from the JVs and Associates as well, as they adjust to newer generation engines maintenance cycle. While the line maintenace business remains healthy, unexciting expansion in Changi Airport throughput will place a cap on growth in the near-term, with Terminal 4 and Terminal 5 only expected to be operational in 2017 and 2025 respectively.

Medium-term growth strategy holds the key. The fleet management JV with Boeing – SIAEC's first JV with an airframe OEM – holds potential to increase the breadth of SIAEC's market share amongst the airlines by leveraging the OEM's wide network of customers, despite the risk of partial cannibalisation of existing fleet management services. The 3rd Clark hangar has experienced delays in completion but is expected to come online in the early part of next year, and should double the company's capacity in The Philippines. Over the next 2-3 years, management is predicting that the aircraft MRO cycle should move towards its peak again, which will hopefully boost revenues and profits in the medium term.

Limited growth in FY16/17, but M&A potential deserves a premium. Our earnings estimates remain unchanged. In light of the sustained weakness in both the heavy maintenance segment and engine shop earnings, we are not expecting much earnings growth in FY15-17. However, as we have highlighted in our report dated 6th August 2015 titled 'Does Consolidation Make Sense?', we believe SIAEC's complementary service offerings with ST Aerospace, cost synergies and the potential benefits of scaling up make it a prime candidate for merger or takeover, in particular by ST Engineering. SIE's strong balance sheet, steady dividend potential and potential M&A story thus serve to sustain investor interest in the stock.

Valuation:

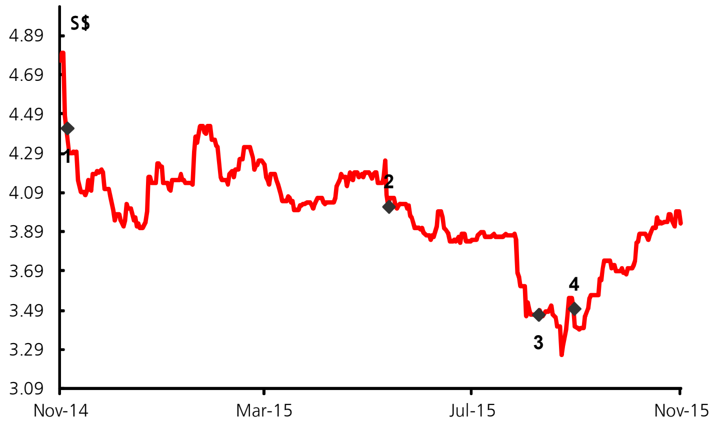
We maintain HOLD on the back of balance sheet strength, dividend yield support and potential M&A activity. Our TP of S$3.84 is based on a blended valuation framework (PE, dividend yield and DCF), and includes a 20% M&A candidate premium.

Key Risks:

Slow growth at certain associates and joint ventures (JVs). Some of the engine MRO JVs cater to older widebody models, which are being phased out. Demand may be negatively affected as a result.

Risk of cannibalisation remains salient. New JVs and associates, such as the Boeing fleet management JV, carry the risk of cannibalising some of the group's existing revenue lines, which could slow growth.

Target Price & Ratings History



S.No.	Date	Closing Price	Target Price	Rating
1:	06 Nov 14	4.42	3.80	FULLY VALUED
2:	14 May 15	4.02	3.70	FULLY VALUED
3:	10 Aug 15	3.47	3.70	HOLD
4:	31 Aug 15	3.50	3.52	HOLD

***Note**: Share price and Target price are adjusted for corporate actions.*

Source: DBS Bank

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BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
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Share price appreciation + dividends

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DBS Bank Ltd.
12 Marina Boulevard, Marina Bay Financial Centre Tower 3
Singapore 018982
Tel. 65-6878 8888
Company Regn. No. 196800306E