

ST Engineering (STE SP)

Good execution

Capitalising on strong order book, reiterate BUY

STE reported 1H PATMI of SGD336.5m, +10% HoH/+19.9% YoY. Growth was driven by mid-teens top-line growth and better margins. Barring SATCOM, other business segments saw healthy revenue growth of low to high teens. New order wins in the quarter came in at a similar level as the prior quarter, resulting in further order book growth. With healthy order book and continued cost controls, STE is on track to deliver mid-teens earnings growth over next 12 months while offering a mid-single digit yield. We lift our TP to SGD4.80 from SGD4.60. BUY.

Key business segments up, SATCOM work in progress

1H group revenue of SGD5.5b grew 5% HoH/14% YoY. CA grew by 9% HoH/20% YoY on strong growth in aerospace MRO and aero structures & systems. DPS saw 11% HoH/12% YoY growth led by digital systems & cyber as well as marine. USS revenue was -13% HoH/+3% YoY as growth in urban solutions (which includes TransCore) was offset by weakness in SATCOM. 1H group EBIT of SGD523m grew 11% HoH/18% YoY. This was helped by top-line growth as well as better margins. 1H EBIT margin came in at 9.5%, 50bps/40bps higher HoH/YoY. In particular, productivity gains and lower procurement costs helped to mitigate inflationary pressures and margin pressures from change in sales mix in CA business. SATCOM business continues to face disruption from new technologies and entrants. Mgmt. guided to cost mgmt. and upcoming new product offering to tackle these challenges, though execution risk remains.

Growing order book

Order book stood at SGD27.9b (1Q 27.7b, 1QFY23 27.5b). New order wins of SGD3.1b in the quarter was well spread across the three business verticals (CA, DPS, USS). Strong order book and steady execution provides revenue visibility into the forecast years. However, rate of order book growth is past its peak and will show up in top line and bottom line comps at some point in time. Maintenance of older fleets used by airlines, international defense order wins and contracts wins by Transcore can further accelerate order book growth organically.

Maintain BUY

We leave estimates unchanged with operating profit tracking our full year est. However, 20bps reduction in cost of capital to 8.4% due to lower risk free rate results in higher DCF-based TP of SGD4.8. STE provides a good combination of visible mid-teens earnings growth and 5% yield at a reasonable price of 10.5x EV/EBITDA in line with historical mean.

FYE Dec (SGD m)	FY22A	FY23A	FY24E	FY25E	FY26E
Revenue	9,035	10,101	10,994	11,764	12,692
EBITDA	1,252	1,456	1,658	1,907	2,231
Core net profit	535	586	707	797	932
Core EPS (cts)	17.1	18.8	22.6	25.5	29.9
Core EPS growth (%)	(5.0)	9.6	20.5	12.8	17.0
Net DPS (cts)	16.0	16.0	21.1	23.8	27.9
Core P/E (x)	19.6	20.7	19.3	17.1	14.6
P/BV (x)	3.9	4.4	4.6	4.1	3.7
Net dividend yield (%)	4.8	4.1	4.8	5.5	6.4
ROAE (%)	22.2	24.1	27.6	28.3	29.5
ROAA (%)	4.2	3.9	4.4	4.7	5.3
EV/EBITDA (x)	13.3	12.5	11.3	9.6	8.1
Net gearing (%) (incl perps)	223.6	209.1	160.3	130.7	111.1
Consensus net profit	-	-	684	794	883
MIBG vs. Consensus (%)	-	-	3.3	0.4	5.6

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BUY

Share Price	SGD 4.37
12m Price Target	SGD 4.80 (+10%)
Previous Price Target	SGD 4.60

Company Description

STE is an engineering conglomerate with business in commercial aerospace, urban solutions & SATCOM and defence & public security.

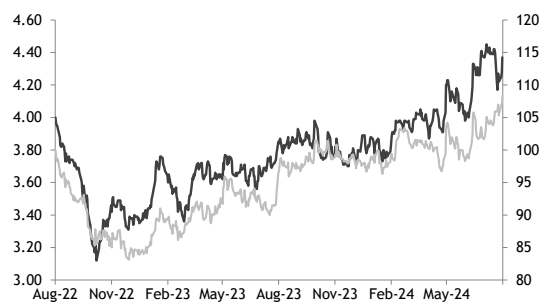
Statistics

52w high/low (SGD)	4.45/3.70
3m avg turnover (USDm)	14.8
Free float (%)	48.1
Issued shares (m)	3,122
Market capitalisation	SGD13.6B
	USD10.4B

Major shareholders:

Temasek Holdings Pte Ltd. (Investment Co)	49.8%
Capital Research & Management Co. (Globa)	3.3%
BlackRock Fund Advisors	1.4%

Price Performance



	-1M	-3M	-12M
Absolute (%)	(0)	4	14
Relative to index (%)	7	6	13

Source: FactSet

Abbreviations explained

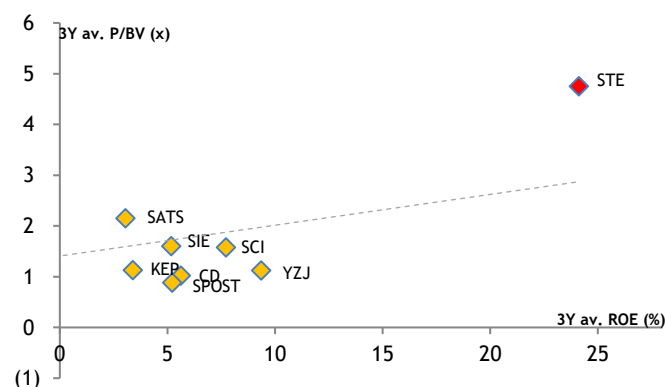
CA - Commercial Aerospace
DPS - Defence and Public Security
USS - Urban Solutions and SATCOM
MRO - Maintenance, repair, and overhaul

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Tear Sheet Insert

Value Proposition

- STE has a 50-year history as Singapore’s primary defence contractor. In recent decades it has successfully evolved its operations to tap the commercial marketplace and presently the split between commercial and defence derived revenues is roughly 55:45.
- STE’s operating segments are aligned by the commercial aerospace, urban solution & satellite communication and defence & public security sectors.
- The value proposition it offers customers is the ability to leverage a deep pool of engineering expertise across multiple sectors to deliver tailored solutions.
- STE is also one of the largest and non-airline affiliated aviation MRO providers in the world.

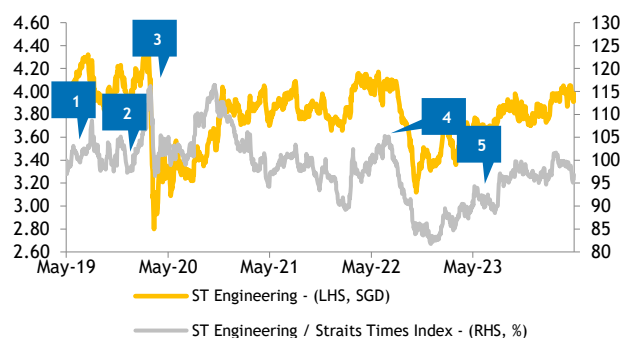
Singapore large-cap industrials - historical P/BV vs ROE



Source: Company

Price Drivers

Historical share price trend



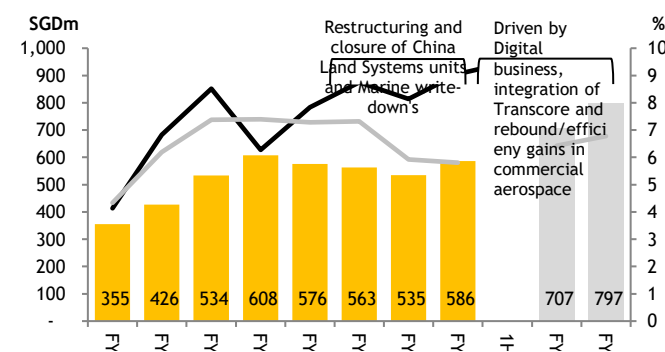
Source: Company, Maybank IBG Research

1. Multiple stock rating upgrades from the street.
2. Large contract win of SGD1b with options up to SGD2.6b for US marine subsidiary VT Halter Marine after a prolonged dry spell of material contract awards.
3. Global pandemic strikes causing huge disruption to aviation industry.
4. Singapore Technologies Engineering is marking its largest acquisition to date with the USD2.68b (SGD3.64b) all-cash offer for a group of entities under Roper Technologies focused on transport management systems.
5. Gradual rebound in MRO business, demand for PTF business and growth in Digital business within Defence and Public Security business

Financial Metrics

- Key factors driving our expectation of a blended margin recovery in FY23-FY25E: higher EBITDA margin from aerospace, growth of digital business and monetisation from inorganic growth.
- Aside from improving margins, robust aerospace and defence order books with relatively stable smart city initiatives underpin our 15% core PATMI CAGR forecast.
- We expect ROE to rebound from 24% in FY23 to 27% by FY26E.

Expecting PATMI and margin improvements



Source: Company

Swing Factors

Upside

- Higher-than-expected passenger to freighter work from airlines upgrading their passenger fleets with cargo growth supportive.
- Better-than-expected margins if aircraft OEMs slow down their aftermarket expansion (as order books are full).
- The recent Polar Vessel contract win aside, a broader recovery in marine orders 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 where large contracts have been few and far in-between.

Downside

- Ongoing rise in inflation could see a supply crunch in aircraft materials and equipment.
- Structural threat from aircraft OEMs like Boeing and Airbus becoming more aggressive in expanding in the aftermarket-MRO space.
- Major disruption in airborne cargo growth due to the aftermath of a US-China trade war could hurt aircraft PTF conversion demand.

Risk Rating & Score ¹	30.9
Score Momentum ²	-0.1
Last Updated	19 Nov 2021
Controversy Score ³ (Updated: 07 Jun 2022)	2- Customer Incident

Business Model & Industry Issues

- Given the nature of the aviation engineering industry, which accounts for about 2% of direct CO2 global emissions, this number is expected to increase given the projected expansion of air travel. STE's greenhouse gas emissions reduction programme is strong. Furthermore, its carbon intensity trend is observed to have moderately declined over the past three years.
- The aerospace & defence industry is exposed to bribery and corruption risks through its close business relationship with government officials and bodies, and the competition for a limited number of high-value contracts. STE has a policy of zero tolerance in fraud and corruption practices. There were no reported cases of bribery and corruption in 2022.
- Being the largest government contractors, the group is entrusted with managing, storing and processing highly confidential information. Cyberattacks could result in data breaches and leaks of confidential documents, which can have serious consequences on national security matters, and impact companies' costs and operations. The company has average preparedness measures to address data privacy and security issues and has been implicated in minor controversies related to the issue.

Material E issues

- In FY22, STE achieved a 30% absolute GHG emissions reduction as compared to FY21. This translated to a 37% reduction in GHG emissions intensity, which is on track to achieve the Group's target of a 50% reduction by FY30E.
- The Group designed eco-engine wash services - EcoPower which has significant environmental benefits. It washes more than 9,000 aircraft engines annually using innovative and environmentally-friendly processes. These result in fuel savings, which translate to an estimated emissions avoidance of 500,000 tonnes CO2e annually as well as the recovery and reuse of around 2m litres of water.
- In FY22, STE's Singapore operations recycled 75% of 5,900 tonnes of waste generated. The recyclables included wood, metal, batteries and paper products.

Material S issues

- Total Group economic contribution of SGD8.7b, which includes: (i) bought in material and services; (ii) employee wages, salaries and benefits; and (iii) dividends and others.
- As at end Dec 2021, 78% of the workforce is male while 22% is female with 14% turnover rate. Among them, about 14% of female and 15% of male employees are managers.
- In FY22, accident frequency (+37.5% YoY) and severity rate (-5% YoY) per million manhours has been on the uptrend. One of the key factors that contributed to the increase is human error in complying with safety procedures. Key mitigating measures have been imposed through cross sharing of best practices within the global operations.
- Positioning employees for the future of work through workforce transformation programmes including upskilling and reskilling initiatives. Average training of 22.5 hours per employee.

Key G metrics and issues

- STE's board comprises 13 directors and an alternate director. The current board composition has: 9 independent & non-executive directors, 3 non-independent & non-executive director and 1 executive director/ group president & CEO. There are 2 women directors and 11 men directors on the board.
- The nomination, audit, investment and remuneration committees are chaired by independent and non-executive directors.
- The board consists of members with established track record in various industries. The company has a majority standard for election of directors and the company has a resignation policy for directors failing to receive a majority of votes.
- As of March 2022, STE principal shareholders, with stake sizes in percentage of ordinary shares were as follows: Temasek Holdings (49.8%), Capital Research & Management (3.3%) and BlackRock Fund Advisors (1.4%).
- To date, STE has never received or been the subject of any legal action in relation to anti-competitive behaviour and violations of anti-trust and monopoly legislation. There were no reported cases of bribery and corruption in 2021.

¹**Risk Rating & Score** - derived by Sustainalytics and assesses the company's exposure to unmanaged ESG risks. Scores range between 0 - 50 in order of increasing severity with low/high scores & ratings representing negligible/significant risk to the company's enterprise value, respectively, from ESG-driven financial impacts. ²**Score Momentum** - indicates changes to the company's score since the last update - a **negative** integer indicates a company's improving risk score; a **positive** integer indicates a deterioration. ³**Controversy Score** - reported periodically by Sustainalytics in the event of material ESG-related incident(s), with the impact severity scores of these events ranging from Category 0-5 (0 - no reports; 1 - negligible risks; ...; 5 - poses serious risks & indicative of potential structural deficiencies at the company).

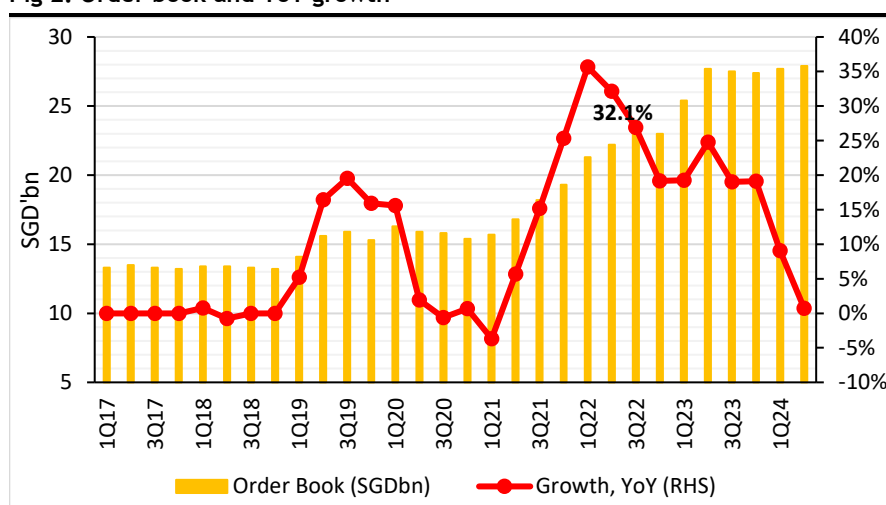
1. 1H Results

Fig 1: 1H details

SGDm.	2Q23	1Q24	2Q24	% QoQ	% YoY	1H23	2H23	1H24	%HoH	% YoY	Comments	FY24e	%FY24e
Segment Revenue													
- CA	983	1,152	1,079	(6)	10	1,856	2,050	2,231	9	20	Revenue growth from MRO and Aerostructures & Systems sub-segments Growth in Digital Systems & Cyber and Marine Higher revenue from Urban Solutions (includes Transcore) offset by lower Satcom revenue	4,239	53
- DPS	1,135	1,123	1,249	11	10	2,117	2,135	2,372	11	12		4,718	50
- USS	457	429	489	14	7	891	1,053	918	(13)	3		2,203	42
Total revenue	2,575	2,704	2,817	4	9	4,864	5,238	5,521	5	14		10,994	50
Segment EBIT													
- CA						178	160	190	19	7	Topline growth offset by lower aircraft sales, project timing and sales mix		
- DPS						301	267	324	22	8			
- USS						(34)	44	9	(80)	NM	Topline growth, cost savings and absence of Satcom one-off loss in 1H23		
Total EBIT						444	471	523	11	18			997
EBIT Margin, %													
- CA						9.6	7.8	8.5					
- DPS						14.2	12.5	13.7					
- USS						NM	4.2	1.0					
Group EBIT Margin						9.1	9.0	9.5					
Order book and new contracts, SGD b.													
Order book	27.7	27.7	27.9										
Execution thru rest of FY	4.4	6.5	4.9										
Contracts for the qtr.	4.7	3.0	3.1										
- CA	2.3	0.8	1.3										
- DPS	1.9	1.7	1.0										
- USS	0.5	0.5	0.9										

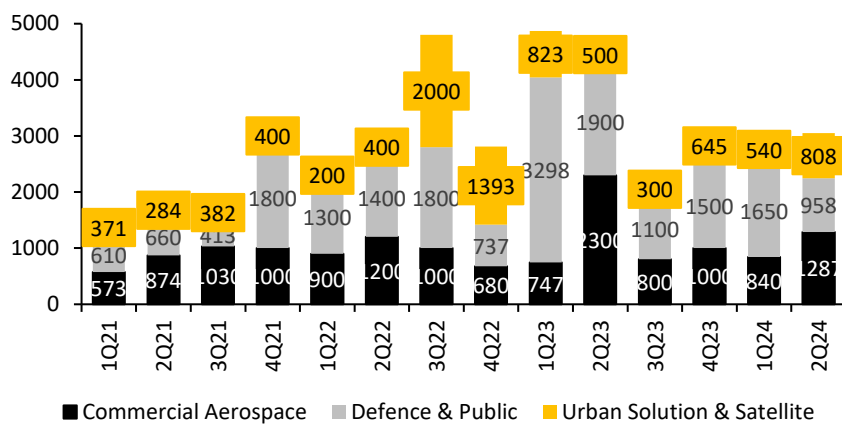
Source: Maybank IBG Research, Company Data

Fig 2: Order book and YoY growth



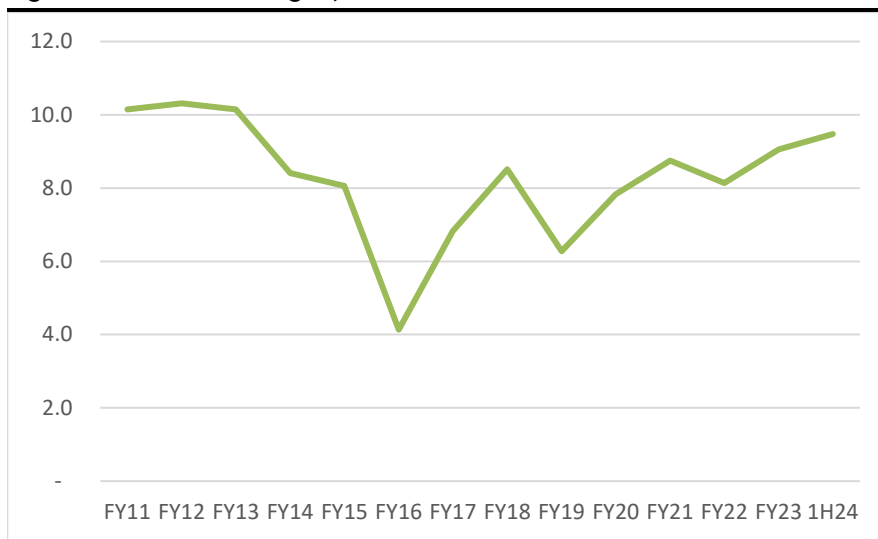
Source: Maybank IBG Research, Company Data

Fig 3: Quarterly order wins by segment, SGDm.



Source: Maybank IBG Research, Company Data

Fig 4: Historical EBIT Margins, %



Source: Maybank IBG Research, Company Data

2. Valuation

We value STE using a DCF model and applying a WACC of 8.4%, lower than prior WACC of 8.6% due to lower risk free rate assumption. The below table summarises the key inputs to the DCF model. We leave our other input assumptions unchanged. 1H revenue and PBT is tracking our full year estimate. Full year run rate of 1H PATMI of SGD336.5 is lower than our full year estimate of SGD706m due to tax and minority interests, which we leave unchanged for now. With lower WACC, we raise our SOTP-based TP to SGD4.80 and maintain BUY.

STE is executing well on its record order book with efficient cost control. EBIT margins are at near historical peaks since 2011. Operational cash flow provides good dividend cover. That said, the order book growth is past its peak, which will eventually catch up with top line and bottom line growth. High gearing in an historical context (following Transcore acquisition) makes large-scale inorganic growth difficult. However, organic growth can come from further order wins in DPS business in international defense, order wins in transportation solutions for Transcore and turnaround of the Satcom business. Interest rate cuts should help the portion of floating debt.

However, reduction of overall debt cost needs a deeper rate cuts as fixed rate debt is priced at 2%.

Fig 5: Discounted Cash Flow Valuation for ST Engineering

FYE Dec (SGDm)	2022A	2023A	2024F	2025F	2026F	2027F	2028F	2029F	2030F
- Commercial Aerospace	3053	3966	4239	4532	4800	5085	5386	5706	6044
- Urban Solutions & SATCOM	1821	1981	2203	2353	2513	2684	2868	3064	3274
- Defence & Public Security	4320	4289	4718	5048	5553	5830	6122	6428	6749
- Others & Elimination	(158)	(134)	(166)	(169)	(173)	(176)	(178)	(181)	(184)
Revenue	9035	10101	10994	11764	12692	13423	14197	15016	15884
Growth YoY, %	17	12	9	7	8	6	6	6	6
EBIT	735	915	997	1097	1190	1284	1358	1437	1520
Operating margin, %	8	9	9	9	9	10	10	10	10
- Adj for taxes	(54)	(100)	(127)	(144)	(127)	(134)	(142)	(150)	(159)
+ Depreciation	338	341	394	428	463	498	534	570	608
+ Amortisation	179	201	179	179	179	179	179	179	179
+ Working cap chgs	(731)	(101)	649	(108)	(179)	(35)	(989)	2	(2)
- Capex	(1056)	(603)	(613)	(623)	(634)	(645)	(656)	(667)	(679)
+ Investment income	40	56	63	64	66	67	69	71	73
FCFF	(549)	709	1542	893	958	1215	354	1442	1539
Year	0	0	1	2	3	4	5	6	7
WACC (%)	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%
Disc. factor (x)	1.00	1.00	0.92	0.85	0.78	0.72	0.67	0.62	0.57
Discounted FCF	(549)	709	1422	760	752	880	236	888	875

DCF summary	SGDm	Key assumptions	%
Terminal Value (TV)	24,026	Risk Free Rate (%)	2.8
TV: Implied EV/EBITDA (x)	8.9	Risk Premium (%)	6.5
		Cost of Equity	9.3
FCFF: 2024-2030 explicit forec	5,813	Cost of debt (or YTM of bond)	3.7
FCFF: TV	14,416	After-tax cost of debt	3.3
Less: Net Debt (Cash)	5,755	Current Net Debt proportion	67.6
FCFE	14,474	LT Net Debt proportion	15.0
O/s shares	3,123	WACC	8.4
FCFE per Share (SGD/share)	4.80	LT Growth Rate	2%

Source: Maybank IBG Research

3. Risks

Risks include: moderation of growth and margins in commercial aerospace, slower-than-expected turnaround of urban solutions and SATCOM business, wage inflation, dilutive M&As and integration challenges.

FYE 31 Dec	FY22A	FY23A	FY24E	FY25E	FY26E
Key Metrics					
P/E (reported) (x)	22.2	19.7	19.3	17.1	14.6
Core P/E (x)	19.6	20.7	19.3	17.1	14.6
P/BV (x)	3.9	4.4	4.6	4.1	3.7
P/NTA (x)	(4.0)	(5.5)	(7.6)	(10.5)	(20.4)
Net dividend yield (%)	4.8	4.1	4.8	5.5	6.4
FCF yield (%)	nm	nm	1.4	nm	nm
EV/EBITDA (x)	13.3	12.5	11.3	9.6	8.1
EV/EBIT (x)	22.6	19.9	18.8	16.6	15.2
INCOME STATEMENT (SGD m)					
Revenue	9,035.1	10,101.0	10,994.0	11,763.5	12,692.4
EBITDA	1,252.0	1,456.1	1,658.5	1,907.3	2,231.5
Depreciation	(337.6)	(340.9)	(393.7)	(427.9)	(462.6)
Amortisation	(179.3)	(200.6)	(179.3)	(179.3)	(179.3)
EBIT	735.1	914.7	997.5	1,097.2	1,190.5
Net interest income / (exp)	(137.6)	(210.4)	(224.2)	(209.6)	(188.7)
Associates & JV	33.3	58.1	64.9	66.5	68.2
Exceptionals	0.0	0.0	0.0	0.0	0.0
Other pretax income	37.3	16.5	8.8	4.8	2.7
Pretax profit	597.5	704.2	847.1	958.9	1,072.6
Income tax	(54.1)	(99.8)	(127.1)	(143.8)	(126.9)
Minorities	(8.3)	(18.0)	(13.3)	(18.0)	(13.3)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	535.0	586.5	706.7	797.1	932.4
Core net profit	535.0	586.5	706.7	797.1	932.4
BALANCE SHEET (SGD m)					
Cash & Short Term Investments	601.8	353.3	1,016.7	1,224.4	1,209.9
Accounts receivable	1,741.4	2,139.1	2,119.0	2,267.3	2,446.3
Inventory	3,783.9	4,137.4	4,604.3	4,926.6	5,315.6
Reinsurance assets	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equip (net)	2,658.1	2,727.3	2,946.7	3,142.1	3,313.2
Intangible assets	5,291.3	4,958.2	4,778.9	4,599.6	4,420.3
Investment in Associates & JVs	468.2	567.4	569.7	572.0	574.4
Other assets	419.3	496.2	496.2	496.2	496.2
Total assets	14,964.1	15,378.9	16,531.4	17,228.3	17,776.0
ST interest bearing debt	3,628.0	2,563.7	2,307.3	2,076.6	1,868.9
Accounts payable	2,868.4	3,205.2	3,724.6	3,955.9	4,203.9
LT interest bearing debt	2,906.6	3,544.4	3,473.5	3,444.1	3,455.2
Other liabilities	2,908.0	3,313.0	4,053.0	4,456.0	4,496.0
Total Liabilities	12,311.1	12,626.6	13,558.7	13,932.7	14,023.5
Shareholders Equity	2,398.0	2,459.3	2,666.5	2,964.0	3,365.6
Minority Interest	254.9	293.0	306.3	324.3	337.6
Total shareholder equity	2,652.9	2,752.3	2,972.8	3,288.2	3,703.1
Total liabilities and equity	14,964.1	15,378.9	16,531.4	17,228.3	17,776.0
CASH FLOW (SGD m)					
Pretax profit	597.5	704.2	847.1	958.9	1,072.6
Depreciation & amortisation	516.9	541.4	573.0	607.1	641.9
Adj net interest (income)/exp	137.6	210.4	224.2	209.6	188.7
Change in working capital	(731.4)	(100.8)	648.6	(108.3)	(179.5)
Cash taxes paid	(47.0)	(91.6)	(118.9)	(135.6)	(118.7)
Other operating cash flow	(2.0)	(2.0)	(2.3)	(2.3)	(1.4)
Cash flow from operations	471.2	1,261.4	2,171.4	1,529.1	1,603.4
Capex	(1,056.1)	(200.8)	(613.1)	(623.3)	(633.8)
Free cash flow	(3,996.2)	913.4	1,714.4	1,177.1	903.5
Dividends paid	(499.6)	(499.6)	(499.6)	(499.6)	(530.8)
Equity raised / (purchased)	0.0	0.0	0.0	0.0	0.0
Change in Debt	4,419.3	(426.4)	(327.3)	(260.2)	(196.5)
Other invest/financing cash flow	(3,549.0)	(357.7)	(68.1)	61.7	(254.8)
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Net cash flow	(214.2)	(223.1)	663.3	207.8	(12.5)

FYE 31 Dec	FY22A	FY23A	FY24E	FY25E	FY26E
Key Ratios					
Growth ratios (%)					
Revenue growth	17.4	11.8	8.8	7.0	7.9
EBITDA growth	16.9	16.3	13.9	15.0	17.0
EBIT growth	9.2	24.4	9.1	10.0	8.5
Pretax growth	(6.3)	17.9	20.3	13.2	11.9
Reported net profit growth	(5.0)	9.6	20.5	12.8	17.0
Core net profit growth	(5.0)	9.6	20.5	12.8	17.0
Profitability ratios (%)					
EBITDA margin	13.9	14.4	15.1	16.2	17.6
EBIT margin	8.1	9.1	9.1	9.3	9.4
Pretax profit margin	6.6	7.0	7.7	8.2	8.5
Payout ratio	93.4	85.2	93.4	93.4	93.4
DuPont analysis					
Net profit margin (%)	5.9	5.8	6.4	6.8	7.3
Revenue/Assets (x)	0.6	0.7	0.7	0.7	0.7
Assets/Equity (x)	6.2	6.3	6.2	5.8	5.3
ROAE (%)	22.2	24.1	27.6	28.3	29.5
ROAA (%)	4.2	3.9	4.4	4.7	5.3
Liquidity & Efficiency					
Cash conversion cycle	94.6	107.5	105.0	100.9	102.6
Days receivable outstanding	65.6	69.2	69.7	67.1	66.8
Days inventory outstanding	155.2	164.5	170.3	174.2	175.6
Days payables outstanding	126.3	126.1	135.0	140.4	139.9
Dividend cover (x)	1.1	1.2	1.1	1.1	1.1
Current ratio (x)	0.8	0.9	1.0	1.0	1.1
Leverage & Expense Analysis					
Asset/Liability (x)	1.2	1.2	1.2	1.2	1.3
Net gearing (%) (incl perps)	223.6	209.1	160.3	130.7	111.1
Net gearing (%) (excl. perps)	223.6	209.1	160.3	130.7	111.1
Net interest cover (x)	5.3	4.3	4.5	5.2	6.3
Debt/EBITDA (x)	5.2	4.2	3.5	2.9	2.4
Capex/revenue (%)	11.7	2.0	5.6	5.3	5.0
Net debt/ (net cash)	5,932.8	5,754.8	4,764.2	4,296.2	4,114.2

Source: Company; Maybank IBG Research

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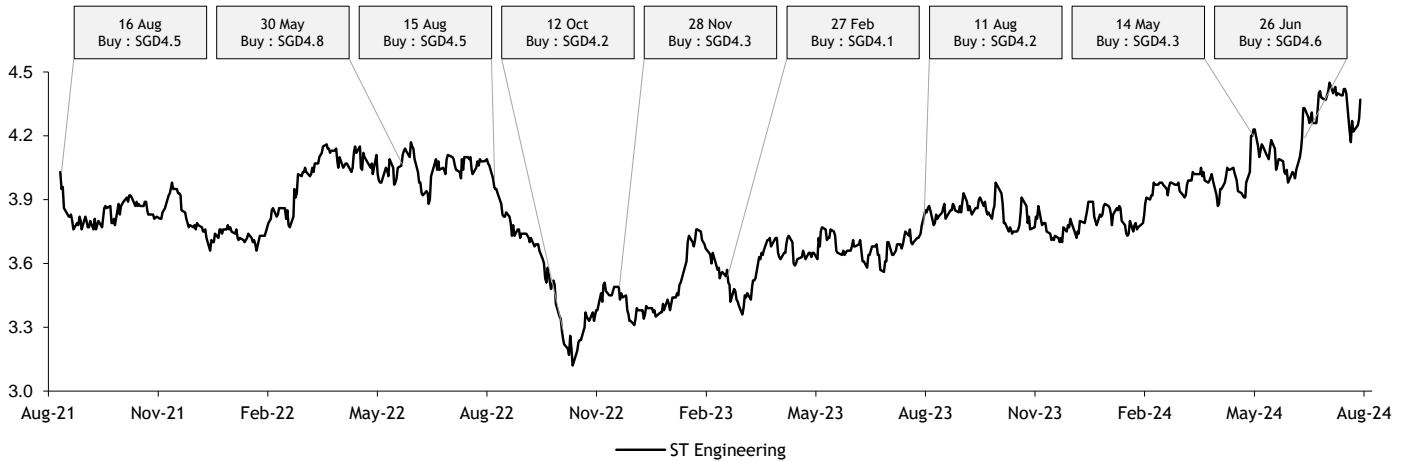
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