

COMPANY UPDATE

Singapore Technologies Engineering (STE SP)

A More Solid BUY With Palatable Valuation

We believe STE's recent share price weakness was triggered by the core profitability miss of its 1H22 results. With STE now trading at 19.5x FY24 PE (based on our more conservative FY24 EPS estimate at 15% below consensus') which is 1.0 SD below historical mean, we think further downside risks of earnings should have been largely priced in. The sustainable dividend yield of 4.3% should provide some support to STE's valuation. Maintain BUY with a lower DCF-based target price of S\$4.07.

WHAT'S NEW

- Share price weakness due to core profitability miss.** Post its 1H22 results release on 12 Aug 22, STE's share price has declined by a cumulative 7.5% (after the adjustment for an interim DPS of 4 S cents) in the past three weeks. We believe that the share price weakness was attributable to: a) the core net profit miss in its 1H22 financial results, and b) the weak sentiment in the general market (Straits Times Index dropped 2.5% during the same period). Based on our check with the company, there has been no major change in the company's business operation and outlook.

STOCK IMPACT

- More palatable valuation with sustainable dividend yield of 4.3%.** Following the share price decline, STE now trades at FY24 PE of 19.5x (1.0SD below historical mean of 21.3x) based on our updated FY24 EPS forecast of 19.1 S cents (our FY24 core EPS forecast is more conservative than peers at 15% below consensus'). STE's annual dividend payment of 16 S cents is sustainable, translating to a yield of 4.3% based on STE's current share price.
- Expecting better core performance in 2H22.** STE remains on the recovery track this year and we expect its core net profit to improve meaningfully to S\$274m (+36% hoh or +56% yoy) in 2H22, driven mainly by: a) a continued recovery/growth of its commercial aerospace (CA) segment, and b) potential higher project deliveries in the defence & public security (DPS) segment. The performance of urban solutions & satcom (USS) is also likely to improve as the mitigation measures adopted by STE to tackle the chip shortage issue (by securing alternative supply, product redesign, etc) gradually bear fruit. Overall, STE has guided to deliver S\$4.6b worth of projects from its orderbook in 2H22; this is S\$1b higher than its project delivery guidance of S\$3.6b for 2H21 a year ago.
- Medium-term growth underpinned by record-high orderbook.** STE's record-high orderbook of S\$22.2b at end-1H22 underpins STE's revenue growth in the medium term. Despite some margin pressures from inflation, we expect STE's core profitability to grow along with the revenue growth. We expect STE's core net profit to return to pre-pandemic levels in 2023 (at S\$552m) before reaching a new high in 2024 (at S\$599m).

KEY FINANCIALS

Year to 31 Dec (S\$m)	2020	2021	2022F	2023F	2024F
Net turnover	7,158	7,693	9,412	9,996	10,400
EBITDA	949	1,044	1,234	1,320	1,385
Operating profit	570	646	741	792	846
Net profit (reported)	522	571	541	552	599
Core net profit	182	321	476	552	599
EPS (S\$ cent)	5.8	10.3	15.2	17.6	19.1
PE (x)	64.4	36.4	24.6	21.2	19.5
P/B (x)	5.1	4.8	5.1	5.0	4.8
EV/EBITDA (x)	13.4	12.1	13.7	12.8	12.2
Dividend yield (%)	4.0	4.0	4.3	4.3	4.3
Net margin (%)	7.3	7.4	5.8	5.5	5.8
Net debt/(cash) to equity (%)	29.7	26.8	199.2	195.0	183.7
ROE (%)	23.1	24.3	23.1	24.0	25.2
Consensus net profit	-	-	583	646	723
UOBKH/Consensus (x)	-	-	0.82	0.85	0.83

Source: STE, Bloomberg, UOB Kay Hian

BUY

(Maintained)

Share Price	S\$ 3.73
Target Price	S\$ 4.07
Upside	+9.2%
(Previous TP)	S\$ 4.40

COMPANY DESCRIPTION

A global technology, defence and engineering group with a diverse portfolio of businesses across the aerospace, smart city, defence and public security segments.

STOCK DATA

GICS sector	Industrials
Bloomberg ticker:	STE SP
Shares issued (m):	3,115.4
Market cap (S\$ m):	11,620.3
Market cap (US\$m):	8,312.7
3-mth avg daily t'over (US\$m):	13.5

Price Performance (%)

52-week high/low	S\$ 4.17/S\$ 3.66			
1mth	3mth	6mth	1yr	YTD
(7.2)	(9.2)	(2.4)	(1.3)	(0.8)

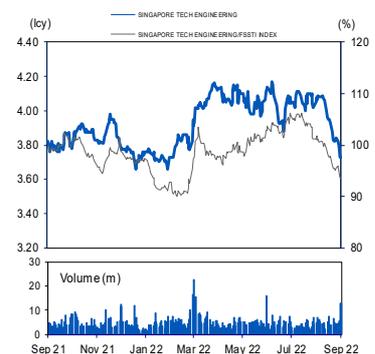
Major Shareholders

Temasek Hldgs	51.7
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FY23 NAV/Share (S\$) 0.73

FY23 Net Debt/Share (S\$) 1.74

PRICE CHART



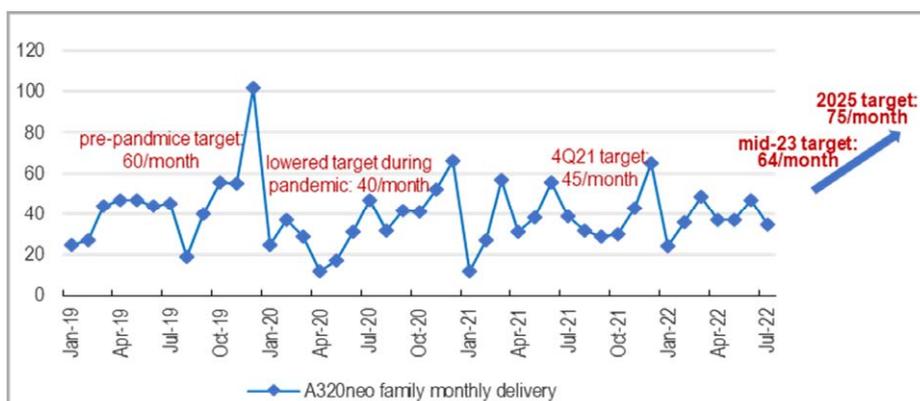
Source: Bloomberg

ANALYST(S)

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• **A fine balance of defensiveness and growth.** As a strategic cornerstone deeply integrated into the defence and public security structure of Singapore, STE is geared to the long-term growth of Singapore's defence and public security spending (3% CAGR in 2010-22). As a globally leading commercial aerospace Maintenance Repair and Overhaul (MRO) solutions provider, STE rides the recovery and growth of the global commercial aerospace sector. Through its 100%-owned subsidiary Middle River Aerostructure Systems (MRAS), STE is the sole supplier of the engine nacelles for LEAP-1A engines installed on Airbus A320neo aircraft (A320neo is the newest model of Airbus A320 family, which is the world's best-selling airliner). As such, STE is a key beneficiary from Airbus' A320neo production ramp-up plan (lifting monthly production rate from currently below 50 to 64 by mid-2023 and to 75 by 2025).

AIRBUS RAMPING UP PRODUCTION OF A320NEO FAMILY AIRCRAFT, TARGETING A MONTHLY PRODUCTION RATE OF 64 BY MID-23 AND 75 BY 2025



Source: Airbus

• **Gearing high but manageable.** Following the major acquisition of TransCore (completed in Mar 22), net gearing of STE elevated to about 194% as at end-1H22, by our estimate. Although the net gearing figure (calculated as net debt over book value of equity) appears lofty, net debt over STE's market cap is only about 43% due to STE's high P/B ratio of 5.0x (reflecting STE's asset-light nature and the overall steadiness of its business portfolio). Instead of simply looking at the net gearing, we use the interest coverage ratio as an alternative gauge to assess the adequacy of STE's capital structure. Despite us incorporating the rising interest rate assumptions in our projection (assuming blended interest cost of 3.2-4.0% in 2022-26), STE's interest coverage (EBIT/cash interest expenses) stands at 4-5x in 2022-26, still a benign level in our view.

EARNINGS REVISION/RISKS

• **2023/24 EPS forecasts trimmed slightly lower by 2.9%/0.7%.** The adjustment is due to slightly higher interest expenses as we fine-tune the interest cost assumptions to reflect the expected interest hikes in the US. Our 2023/24 EPS forecasts are more conservative than peers at 15%/17% below consensus forecasts.

• **Risks:** Stiffer-than-expected margin pressure from inflationary cost pressure, prolonged supply chain disruption and project cost overruns.

VALUATION/RECOMMENDATION

• **Maintain BUY with a lower DCF-based target price of S\$4.07.** We have rolled over our DCF valuation basis to end-23. The cut in target price (from S\$4.40 previously) is due to the adoption of a slightly higher WACC (lifted by 25bp to 7.25%), which provides for the upward pressure on risk-free rates. Our terminal growth assumption remains intact at 2.5%. Our DCF valuation is cross-checked by the PE methodology. Our updated target price implies a FY24 PE of 21.3x, the same as STE's historical mean PE.

SHARE PRICE CATALYST

• Organic profitability growth driven by CA segment recovery/growth and higher DPS project deliveries.

SINGAPORE DEFENCE BUDGET IN STEADY LONG-TERM GROWTH TREND (3% CAGR IN 2010-22)



Source: Singapore Ministry of Finance

ORDERBOOK AT HISTORICAL HIGH



Source: STE

GUIDED ORDERBOOK CONVERSION FOR 2H22 IS S\$1B HIGHER YOY



Source: STE, UOB Kay Hian

STE HISTORICAL PE BAND



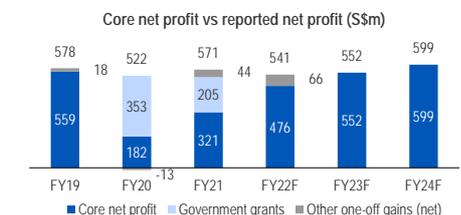
Source: Bloomberg, UOB Kay Hian

STE TARGET PRICE ON VARYING PE PEG

	FY23F	FY24F	FY25F
EPS	S\$0.18	S\$0.19	S\$0.20
P/E peg	Implied TP		
+2SD	24.7x	S\$4.35	S\$4.72
+1SD	23.0x	S\$4.05	S\$4.40
Mean	21.3x	S\$3.75	S\$4.07
-1SD	19.6x	S\$3.45	S\$3.75
-2SD	17.9x	S\$3.15	S\$3.42

Source: UOB Kay Hian

DECOMPOSING PROFITABILITY BETWEEN CORE AND ONE-OFFS



Source: STE, UOB Kay Hian

PROFIT & LOSS

Year to 31 Dec (\$m)	2021	2022F	2023F	2024F
Net turnover	7,692.9	9,411.9	9,995.8	10,400.0
EBITDA	1,044.0	1,234.4	1,320.4	1,385.0
Deprec. & amort.	398.1	493.6	528.3	538.5
EBIT	645.9	740.8	792.1	846.5
Total other non-operating income	11.7	13.4	0.0	0.0
Associate contributions	16.0	22.0	30.0	39.0
Net interest income/(expense)	(36.0)	(107.3)	(145.6)	(142.5)
Pre-tax profit	637.6	668.8	676.5	743.0
Tax	(70.6)	(122.9)	(109.9)	(119.7)
Minorities	3.6	(4.7)	(14.7)	(24.7)
Net profit	570.5	541.2	551.9	598.6

BALANCE SHEET

Year to 31 Dec (\$m)	2021	2022F	2023F	2024F
Fixed assets	2,352.4	2,710.3	2,793.9	2,880.7
Other LT assets	2,806.8	6,446.1	6,386.2	6,326.4
Cash/ST investment	453.8	730.6	815.9	522.6
Other current assets	4,902.7	4,680.7	4,860.1	5,208.0
Total assets	10,515.7	14,567.7	14,856.2	14,937.6
ST debt	559.9	3,242.7	3,242.7	3,242.7
Other current liabilities	4,119.8	4,311.7	4,648.4	4,771.3
LT debt	1,555.3	2,907.3	2,807.3	2,657.3
Other LT liabilities	1,612.5	1,593.4	1,593.4	1,593.4
Shareholders' equity	2,412.8	2,269.0	2,322.6	2,423.0
Minority interest	255.5	243.6	241.8	249.9
Total liabilities & equity	10,515.7	14,567.7	14,856.2	14,937.6

CASH FLOW

Year to 31 Dec (\$m)	2021	2022F	2023F	2024F
Operating	1,114.3	904.8	1,190.6	1,279.2
Pre-tax profit	637.6	668.8	676.5	743.0
Tax	(112.4)	(122.9)	(109.9)	(119.7)
Deprec. & amort.	398.1	493.6	528.3	538.5
Associates	(16.0)	(22.0)	(30.0)	(39.0)
Working capital changes	137.5	16.6	(24.8)	8.9
Other operating cashflows	69.6	(129.3)	150.6	147.5
Investing	(413.7)	(4,296.3)	(449.5)	(453.9)
Capex (maintenance)	(428.8)	(684.6)	(479.5)	(492.9)
Investments	(7.3)	(3,633.6)	0.0	0.0
Others	22.5	22.0	30.0	39.0
Financing	(615.0)	3,098.1	(837.9)	(884.8)
Dividend payments	(467.9)	(685.0)	(498.2)	(498.2)
Proceeds from borrowings	900.7	3,665.0	0.0	0.0
Loan repayment	(877.0)	319.6	(100.0)	(150.0)
Others/interest paid	(170.9)	(201.5)	(239.7)	(236.7)
Net cash inflow (outflow)	85.6	(293.3)	(96.8)	(59.5)
Beginning cash & cash equivalent	729.5	815.9	522.6	425.7
Changes due to forex impact	0.9	0.0	0.0	0.0
Ending cash & cash equivalent	815.9	522.6	425.7	366.3

KEY METRICS

Year to 31 Dec (%)	2021	2022F	2023F	2024F
Profitability				
EBITDA margin	13.6	13.1	13.2	13.3
Pre-tax margin	8.3	7.1	6.8	7.1
Net margin	7.4	5.8	5.5	5.8
ROA	5.6	4.3	3.8	4.0
ROE	24.3	23.1	24.0	25.2
Growth				
Turnover	7.5	22.3	6.2	4.0
EBITDA	10.1	18.2	7.0	4.9
Pre-tax profit	19.3	4.9	1.1	9.8
Net profit	9.3	(5.1)	2.0	8.5
Core net profit	77.0	48.0	16.1	8.5
Core EPS	77.0	48.1	16.1	8.5
Leverage				
Debt to total capital	44.2	71.0	70.2	68.8
Debt to equity	79.3	244.8	235.9	220.7
Net debt/(cash) to equity	26.8	199.2	195.0	183.7

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