ST Engineering

Tailwinds from higher security spending, MRO demand

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- Singapore stepped up defence and security spending by 12% and 17% in FY21 and FY22, respectively. This is expected to rise further, fuelled by heightened geopolitical tensions and cybersecurity threats, providing revenue visibility for STE. Total contracts won for defence and security amounted to S$5.2bn in 1H23, 20.9% higher than the whole of FY22.
- Recovery in air travel will underpin demand for aerospace MRO and components. According to IATA, air passenger-km is still 9.7% below pre-Covid. Asia Pacific's volume is still 20.3% below, and playing catch-up.
- TransCore's acquisition is on track to be earnings accretive from 2H23e, we believe, leading to a positive FY23e EBIT for the urban solutions and Satcom division.
- We initiate coverage with a BUY recommendation and discounted cash flow TP of S$4.50.

Background

ST Engineering (STE) is a global technology, defence and engineering group with a diverse portfolio of businesses across the aerospace, smart city, defence and public security segments. Though STE has built a reputation in strong research and development capability in advanced defence and mobility technologies, about two-thirds of revenue is derived from commercial projects

Highlights

- **Defence spending to climb in the face of heightened geopolitical tensions and cybersecurity threats.** Singapore's defence and security spending expanded by 12% YoY in FY21 and 17% in FY22, well exceeding the 4% average annual growth from 2010-2020. It is expected to rise by 6% in FY23e. As a key Singapore defence contractor, STE will enjoy revenue visibility as more contracts are awarded. STE won S$5.2bn of new orders in 1H23 for defence and public security work. This was 20.9% higher than FY22.

- **Aviation recovery to fuel demand for MRO and aircraft parts.** The aviation sector has bounced back since borders re-opened. Demand for aircraft MRO and components are rising in tandem with increased flight hours and de-mothballing of idle aircraft. According to IATA, total industry passenger-km rose 47.2% YoY in 1H23, though this was still 9.7% below 1H19. Asia-Pacific, which was last to re-open, lags at 20.3%. As Asian air travel gains pace from 2H23e, STE's MRO bases in China, Vietnam and Singapore are poised to gain from higher demand for MRO and components.

- **TransCore is on track to be earnings accretive.** TransCore was acquired in Mar 2022 for S$3.6bn, at a goodwill of S$2.3bn. It booked a net profit of S$61.9mn from Mar to Dec 22. However, this was negated by transaction and integration expenses (FY22: S$30mn, 1H23: S$8mn), increased interest costs and goodwill amortization. In June 2023, TransCore received the notice-to-proceed for the New York Congestion Pricing project, scheduled for completion by 2Q24e. We think this project could lead to more opportunities in other US cities. Transcore is on track to be earnings accretive from 2H23e with contribution from this project and the fading of transaction and integration expenses.

Initiate coverage with a Buy recommendation and TP of S$4.50.

Our TP is based on the discounted cash flow model. The operations generate strong cash flows. We expect it to deliver ROE and ROIC of 26.1% and 14.6% in FY24e.

BUY (INITIATION)

LAST CLOSE PRICE	SGD 3.860
FORECAST DIV	SGD 0.160
TARGET PRICE	SGD 4.500
TOTAL RETURN	20.7%

COMPANY DATA

BLOOMBERG CODE:	STE SP
O/S SHARES (MN) :	3,116
MARKET CAP (USD mn / SGD mn) :	8805 / 12028
52 - WK HI/LO (SGD) :	3.94 / 3.12
3M Average Daily T/O (mn) :	3.98

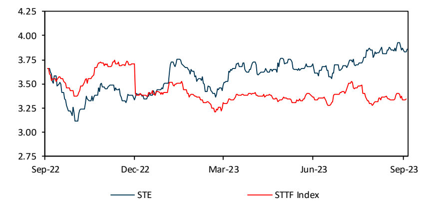
MAJOR SHAREHOLDER (%)

TEMASEK HOLDINGS	50.0%

PRICE PERFORMANCE (%)

	1MTH	3MTH	1YR
COMPANY	1.1	7.2	8.5
STTF RETURN	1.5	1.2	3.1

PRICE VS. STTF



Source: Bloomberg, PSR

KEY FINANCIALS

Y/E Dec (S$, 'mn)	FY21	FY22	FY23e	FY24e
Revenue	7,693	9,035	9,711	9,906
Gross Profit	1,535	1,699	1,909	2,194
EBIT	674	735	827	1,031
NPAT	571	535	560	692
P/NAV (x)	5.0	5.0	4.9	4.5
P/E (x)	21.1	22.5	21.5	17.4
ROE (%)	23.6%	22.3%	22.8%	26.1%

Source: Company, PSR

VALUATION METHOD

Discounted cash flow method

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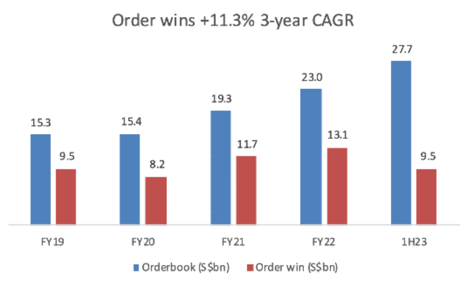
Orderbook

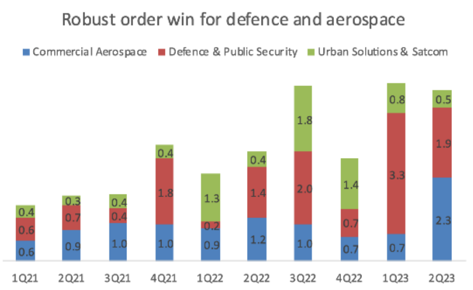
As at end Jun 23, the orderbook stood at a record S$27.7bn. New order wins grew by 11.3% CAGR from FY19 to FY22 (Figure 1). Total orders won in 1H23 were S$9.5bn, comprising 54% defence and public security contracts, 32% commercial aerospace and 14% urban solution and Satcom (Figure 2).

Figure 1: Order wins grew at a 3-year CAGR of 11.3%



Source: Company, PSR

Figure 2: Total orders won reached S$9.5bn in 1H23

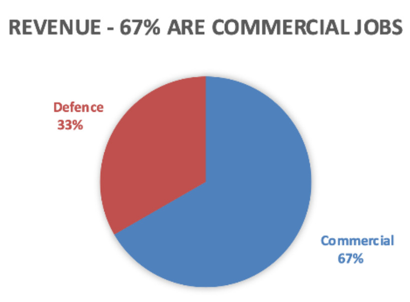


Source: Company, PSR

Background

ST Engineering is a global technology, defence and engineering group with a diverse portfolio of businesses across the aerospace, smart city, defence and public security segments. Though STE has built a reputation for strong research and development capability in advanced defence and mobility technologies, about two-thirds of revenue is derived from commercial projects (Figure 3).

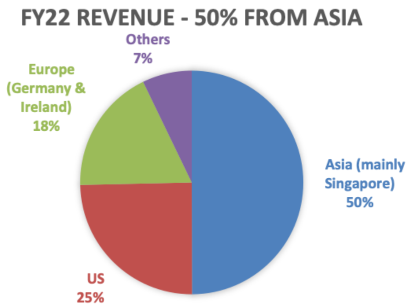
Figure 3: 67% of revenue is derived from commercial jobs



Source: Company, PSR

Asia is its biggest market (Figure 4) and Singapore is an important market where it supports defence and public infrastructure projects. In Europe, it has a strong presence in Germany and Ireland due to its tie-up with Airbus for the passenger-to-freighter, or PTF conversion programme.

Figure 4: Asia accounts for 50% of revenue

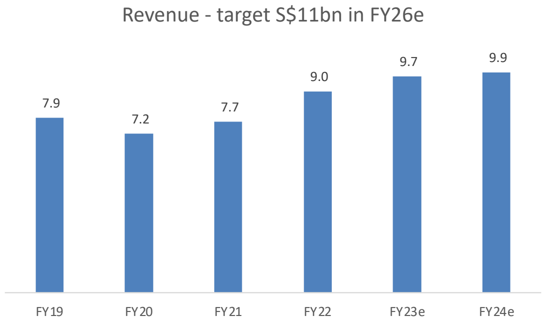


Source: Company, PSR

Revenue bounced back after the lull in FY20 when it faced delays in project execution and order deferment. Strong recovery in commercial aerospace, and the acquisition of TransCore in March 2022, which added revenue of S$620mn, more than offset the loss of revenue from US Marine which was divested in FY22.

STE has set a revenue target of S$11bn for FY26e (Figure 5), of which S$3bn will be derived from sustainability-linked projects. Revenue growth is projected at 2 to 3 times the global GDP growth rate.

Figure 5: Revenue has been rising with a target of S$11bn set for FY26e

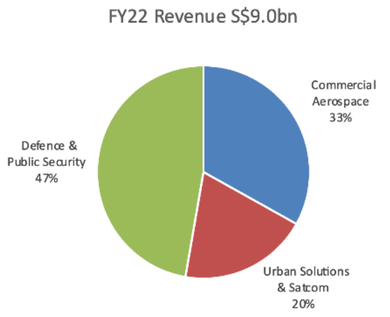


Source: Company, PSR

STE's operations are grouped under three divisions: Commercial Aerospace (CA), Urban Solution and Satcom (USS), and Defence and Public Security (DPS). Their share of revenue and EBIT is shown in Figures 6 & 7. DPS is expected to remain the largest contributor and spearhead growth in the next two years. (Figure 8).

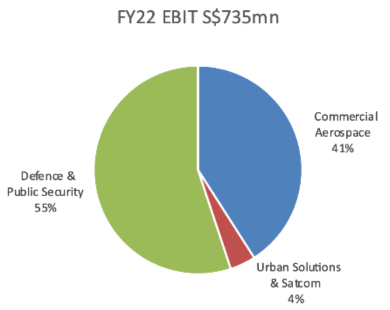
DPS commands a higher margin and is the bedrock of earnings (Figure 9). This is due to the defensive nature of the operations. STE sometimes collects a deposit or advance payments from customers.

Figure 6: Share of revenue from the three divisions



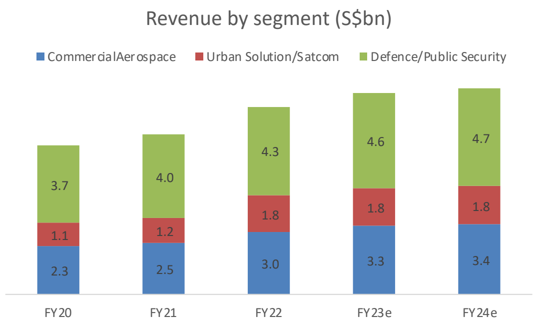
Source: Company, PSR

Figure 7: Share of EBIT from the three divisions



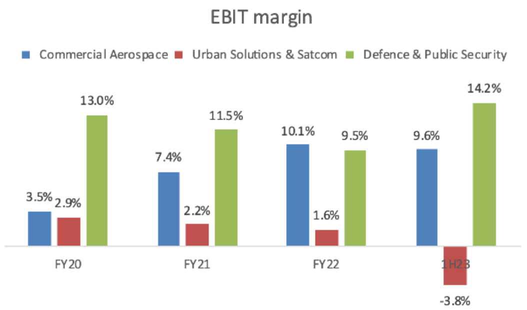
Source: Company, PSR

Figure 8: Defence and public security is expected to spearhead revenue growth



Source: Company, PSR

Figure 9: Defence and public security command higher margin



Source: Company, PSR

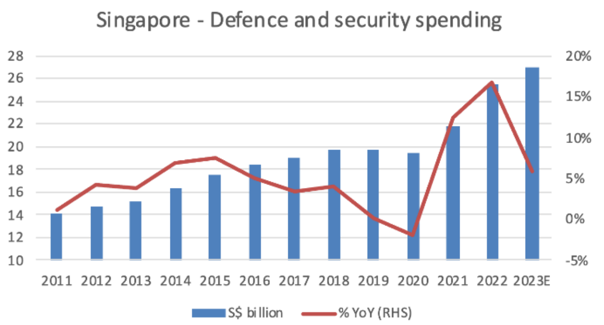
Defence & Public Security

Defence & Public Security (DPS) encompasses defence, public safety and security, and critical information infrastructure solutions. It comprises digital systems and cyber, land systems, marine and defence aerospace. This segment took the lion's share of 47% of revenue and 55% of EBIT in FY22 and commands the highest margin. The divestment of loss-making US Marine operations in FY22 lifted EBIT margin to 14.2% in 1H23 (FY22: 9.5%).

In 1H23, DPS secured new contracts of S$5.2bn, or 58% of total contract wins. It also expanded its international defence business with more than S$100mn contract wins from customers in Europe and the Middle East.

Singapore's defence and security spending rose by 12.2% and 16.7% in FY21 and FY22, respectively. This is expected to grow by 5.9% in the 2023 budget (Figure 10).

Figure 10: Singapore's budget for defence and security surged in the last two years



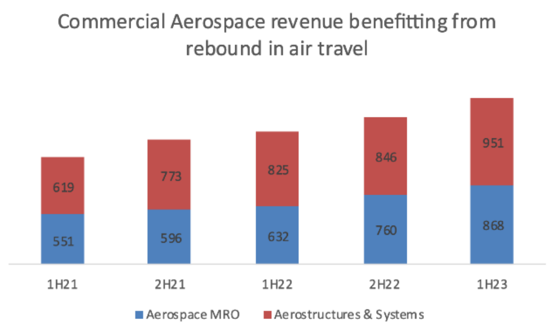
Source: Company, PSR

Commercial Aerospace

This division comprises three core activities: 1) Maintenance, repair and overhaul of airframe, engine and components (MRO); 2) Nacelle and composite manufacturing, passenger-to-freighter conversions for both narrowbody and wide-body aircraft, cabin interiors and engineering solutions and unmanned air systems (Aerostructures & Systems); and 3) Aviation asset management for aircraft and engine under 50%-owned joint ventures with industry partners. Total assets under management amounted to S$1.96bn as at June 2023.

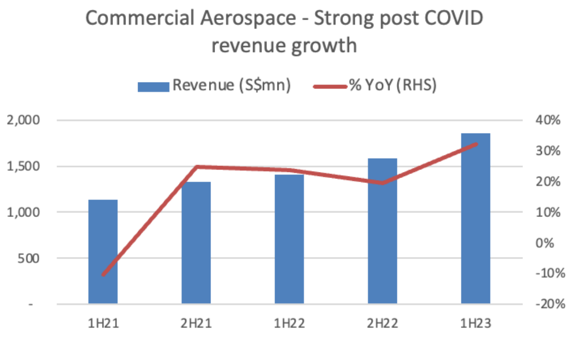
Total contract wins in 1H23 were S$3bn, of which S$2.3bn were secured in 2Q23, pointing to strong underlying demand for aerospace MRO (Figure 11). Since the borders re-opened, STE's aerospace revenue has grown in tandem. (Figure 12).

Figure 11: Strong contract wins in commercial aerospace



Source: Company, PSR

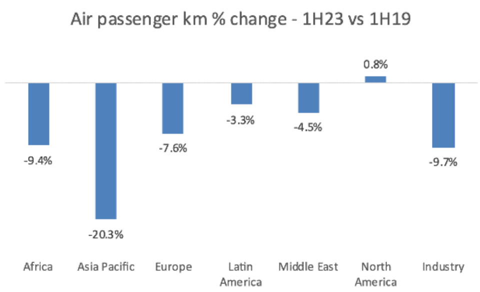
Figure 12: Aerospace revenue has grown by leaps and bounds



Source: Company, PSR

According to IATA, 1H23 air passenger-km was still 9.7% below the pre-Covid level in 1H19. Asia Pacific, which was last region to re-open, lagged at 20.3% lower than 1H19's level. There is therefore room for MRO demand to grow (Figure 13).

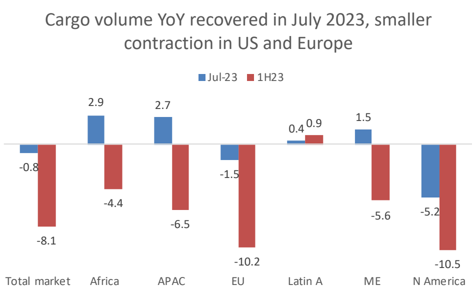
Figure 13: Air passenger-km is still below pre-Covid level and has room to recover



Source: IATA, PSR

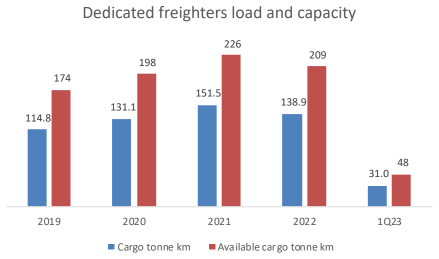
Industry cargo tonne-km fell 8.1% in 1H23, due to the decline in global manufacturing activities. However, the decline abated in July with a smaller fall of -0.8% (Figure 14). Notably, the developing economies, in particular Asia Pacific posted positive growth. This bodes well for freighters, which have a dominant two-third share of the air cargo market. The share has been held steady despite the addition of cargo capacity from the return of bellyhold capacity on passenger flights.

Figure 14: Cargo volume is recovering



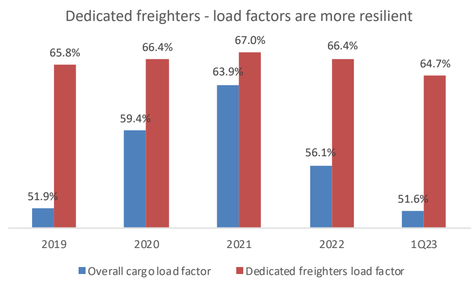
Source: IATA, PSR

Figure 15: Dedicated freighters take the bigger share of loads



Source: IATA, PSR

Figure 16: Dedicated freighters enjoy resilient load factors



Source: IATA, PSR

Urban Solutions and Satcom (USS)

The Smart City business under Urban Solutions covers the areas of Smart Mobility, IoT and Smart Security in Asia, the Middle East and the Americas. This segment faced headwinds in the last three years due to Covid lockdowns, which hampered contract progress (Figure 17).

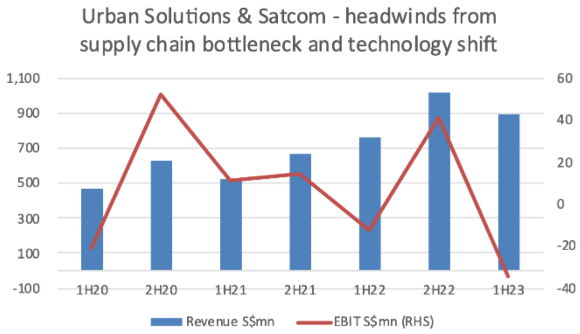
In March 2022, it completed the acquisition of TransCore for S$3.6bn, which is a leader in the transportation industry in North America for tolling systems, congestion pricing, real-time traffic and incident management, and RFID solutions for rail, airports, carparks and trucking fleets.

TransCore contributed S$1.8bn orderbook and S$620.6mn revenue in FY22. It booked a net profit of S$61.9mn from Mar to Dec 2022, but this was negated by S$30mn transaction and integration (T&I) expenses, higher interest expenses and goodwill amortization. T&I expenses fell to about S$8mn in 1HY23, and are expected to taper in 2H23e.

In June 2023, TransCore received the notice-to-proceed (NTP) for the New Work Congestion Pricing project. This project is scheduled for completion in 2Q24. TransCore's project deliveries are expected to be backloaded in 2H23. STE is also expected to commence work on the smart mobility project for rail and road in Kaohsiung.

Satcom earnings have been hurt by the shortage of chips and they continue to face supply chain challenges. The industry is moving towards cloud-based solutions and open standards in satellite ground technology. And STE is working towards full virtualization of its remote satellite modem. It incurred severance pay of S$2mn in 1H23, and a divestment loss of S$24mn on the disposal of SatixFy in Apr 2023. As a result, USS reported a 1H23 EBIT loss of S$34mn. However, we expect positive EBIT for FY23e, as higher profits from TransCore more than offset the loss in 1H.

Figure 17: Choppy EBIT due to Covid lockdowns, supply chain bottom neck and Satcom restructuring

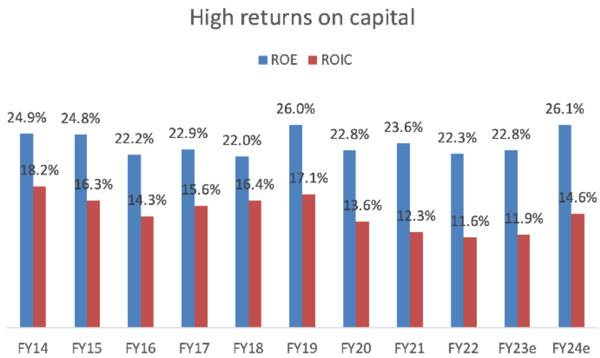


Source: Company, PSR

Financials

The operation generates a strong ROE of above 20% (Figure 18). ROIC, which dipped to 11.6% in FY22, is expected to climb from FY23e as earnings growth turns positive. We think the high returns are due to: 1) the scale of its operations which gives it operating leverage; 2) the defensive nature of its operations; 3) strategic knowhow and intellectual properties employed; and 4) its unique positioning as a contractor for Singapore's defence, public security and public infrastructure.

Figure 18: High returns on capital



Source: Company, PSR

Net debt has risen to S$5.8bn and net gearing to 2.1x in June 2023, after FY22's acquisition of Transcore. However, management expects to keep the average cost of debt at a low 3% in FY23e (FY22: 2.4%) and mid 3% in FY24e.

Financials

Income Statement

Y/E Dec, ($'mn)	FY20	FY21	FY22	FY23e	FY24e
Revenue	**7,158**	**7,693**	**9,035**	**9,711**	**9,906**
Cost of sales	(5,631)	(6,158)	(7,336)	(7,803)	(7,712)
Gross Profit	**1,527**	**1,535**	**1,699**	**1,909**	**2,194**
Selling and distribution	(225)	(183)	(195)	(209)	(214)
Administration	(595)	(608)	(727)	(782)	(797)
Others	(141)	(87)	(75)	(124)	(185)
Share of results of associates an	30	16	33	33	33
EBIT	**596**	**674**	**735**	**827**	**1,031**
Net finance expenses	(62)	(36)	(138)	(194)	(251)
Profit before tax	**534**	**638**	**597**	**633**	**780**
Taxation	(9)	(71)	(54)	(63)	(78)
Net Profit	**526**	**567**	**543**	**570**	**702**
Minority interests	(4)	4	(8)	(10)	(10)
Profit attributable to owners	**522**	**571**	**535**	**560**	**692**

Per share data (S$ cents)

Y/E Dec	FY20	FY21	FY22	FY23e	FY24e
BVPS	73.5	77.5	77.0	79.0	85.2
DPS	15.0	15.0	16.0	16.0	16.0
EPS	16.7	18.3	17.2	18.0	22.2

Cash Flow

Y/E Dec, ($'mn)	FY20	FY21	FY22	FY23e	FY24e
CFO					
Pretax profit	**534**	**638**	**597**	**633**	**780**
Adjustments	473	446	618	755	800
WC changes	598	139	(442)	95	(39)
Cash generated from ops	**1,604**	**1,223**	**774**	**1,484**	**1,541**
Others	(117)	(118)	(133)	(308)	(255)
Cashflow from ops	**1,488**	**1,105**	**641**	**1,175**	**1,286**
CFI					
CAPEX, net	(200)	(312)	(763)	(500)	(500)
Others	(108)	(126)	(3,849)	-	-
Cashflow from investments	**(308)**	**(438)**	**(4,612)**	**(500)**	**(500)**
CFF					
Dividends paid to owners	(485)	(484)	(695)	(498)	(498)
Proceeds from borrowings, net	(399)	(49)	4,491	-	-
Others	(16)	(48)	(26)	-	-
Cashflow from financing	**(900)**	**(581)**	**3,770**	**(498)**	**(498)**
Net change in cash	279	86	(201)	177	288
Cash at the start of the period	452	729	816	602	779
Currency translation	(2)	1	(14)	-	-
Ending cash	**729**	**816**	**602**	**779**	**1,067**

Source: Company, Phillip Securities Research (Singapore) Estimates

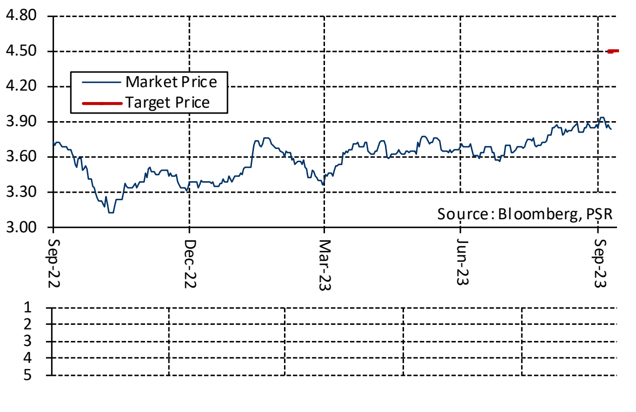
Balance Sheet

Y/E Dec, ($'mn)	FY20	FY21	FY22	FY23e	FY24e
ASSETS					
PPE & Investment Properties	1,757	1,794	2,076	2,249	2,421
Others	3,216	3,365	6,761	6,466	6,186
Total non-current assets	**4,973**	**5,159**	**8,837**	**8,715**	**8,607**
Cash and cash equivalents	731	816	602	779	1,067
Inventories	1,269	1,261	1,684	1,603	1,585
Trade and other receivables	1,048	1,067	1,152	1,197	1,221
Others	1,541	2,213	2,689	2,689	2,689
Total current assets	**4,589**	**5,356**	**6,127**	**6,268**	**6,561**
Total Assets	**9,561**	**10,516**	**14,964**	**14,983**	**15,168**
LIABILITIES					
Trade and other payables	1,668	2,613	2,826	2,886	2,852
ST borrowings	496	560	3,628	3,628	3,628
Others	1,732	1,507	1,551	1,439	1,454
Total current liabilities	**3,896**	**4,680**	**8,005**	**7,953**	**7,934**
LT borrowings	1,551	1,555	2,907	2,907	2,907
Others	1,540	1,612	1,399	1,399	1,399
Total non-current liabilities	**3,091**	**3,168**	**4,306**	**4,306**	**4,306**
Total liabilities	**6,987**	**7,847**	**12,311**	**12,259**	**12,240**
EQUITY					
Share Capital	896	896	896	896	896
Retained profits	1,402	1,548	1,473	1,534	1,728
Others	276	224	284	294	304
Total equity	**2,575**	**2,668**	**2,653**	**2,724**	**2,928**
Total equity and liabilities	**9,561**	**10,516**	**14,964**	**14,983**	**15,168**

Valuation Ratios

Y/E Dec	FY20	FY21	FY22	FY23e	FY24e
P/E (x)	23.1	21.1	22.5	21.5	17.4
P/B (x)	5.2	5.0	5.0	4.9	4.5
EV/EBITDA (x)	14.0	12.8	15.2	12.5	10.8
Dividend yield (%)	3.9	3.9	4.1	4.1	4.1
Growth & Margins (%)					
Growth					
Revenue	-9.0%	7.5%	17.4%	7.5%	2.0%
Gross profit	-7.2%	0.5%	10.7%	12.4%	14.9%
EBIT	-18.3%	13.0%	9.1%	12.4%	24.8%
PBT	-23.1%	19.3%	-6.3%	5.9%	23.2%
Margins					
Gross profit margin	21.3%	20.0%	18.8%	19.7%	22.1%
EBIT margin	8.3%	8.8%	8.1%	8.5%	10.4%
Net profit margin	7.3%	7.4%	5.9%	5.8%	7.0%
Key Ratios					
ROE	22.8%	23.6%	22.3%	22.8%	26.1%
ROA	6.0%	6.1%	4.4%	5.3%	6.6%
Net Gearing	51.1%	48.7%	223.6%	211.3%	186.7%

Ratings History



PSR Rating System

Total Returns	Recommendation	Rating
> +20%	Buy	1
+5% to +20%	Accumulate	2
-5% to +5%	Neutral	3
-5% to -20%	Reduce	4
< -20%	Sell	5

Remarks

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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