9 February 2018

Austal Limited (ASB)

HOLD **Share Price: A$1.78**

Holding pattern

Target Price: A$1.80

We re-instate coverage of ASB given a change in Analyst responsibilities. Following the award in Nov-17 of part of the OPV construction contract, the market awaits more detail on how this project will be undertaken; who gets what roles, how losses are shared and how learnings are applied across the consortium. We take a prudent view in our modelling and assume that ASB will share the construction role (50:50) with Civmec. With an update due this month, some clarity is coming; however, caution that it may not be until construction is underway that ambiguity disappears, and for ASB this is now 2H20. Attention now will no doubt turn to the Future Frigate programme (mid-2018), and ASB's ability to win part of this work as a sub-contractor. We remain cautious for now factoring no award of work, as the tender process covers an international field, and ASB will work in a supporting role, teaming with ASC. Nonetheless, with throughput improving at the Henderson site, any incremental work here should drop through at higher implied margins, given scale efficiencies and any award would be upside to our forecasts and therefore valuation. While the Commercial (ferry) business and a more supportive Australian defence budget position are supportive, the overhang of uncertainty around these key projects could see the share price remain range bound for now, in our view. Due to changes in forecasting (largely for OPV), our DCF derived TP falls 5c to $1.80.

Changes to forecasts

- We remove build of OPV 1 and 2 from our modelling.
- We assume that ASB and Civmec share the build (50:50). We make no changes to margin estimates across the OPV project, at this stage.
- We reduce working capital ramp-up and capex to reflect delayed start to the project from our previous modelling assumptions.

Hold maintained, TP $1.80 (from $1.85)

- Due to the changes we outline above, and rolling forward our DCF by 1yr (Dec-18), our target price falls -5c to $1.80.
- With the share price currently broadly in line with our current price target, we maintain a Hold recommendation.
- Our valuation is based on WACC of 10% and LT growth of 3%, which all remain unchanged.

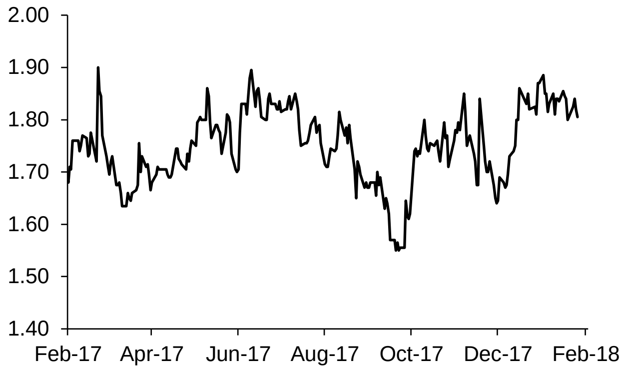
Company Data

Shares – ordinary (M)	350.5
Dilution (M)	0
Total (fully diluted) (M)	350.5
Market capitalisation ($M)	622.1
12 month low/high ($)	1.45 / 1.90
Average monthly turnover ($M)	30.0
Index	All Ordinaries
GICS Industry	Capital Goods

Financial Summary (fully diluted/normalised)

Year end June	FY16A	FY17A	FY18F	FY19F	FY20F
Revenue ($M)	1321.8	1310.1	1403.5	1233.0	1079.9
Costs ($M)	(1,273.9)	(1,219.9)	(1,307.6)	(1,137.8)	(992.1)
EBITDA ($M)	47.9	90.2	95.8	95.3	87.8
NPAT ($M)	7.9	32.7	38.9	35.7	30.4
EPS (¢ps)	2.3	9.3	11.1	10.2	8.7
EPS Growth (%)	n/a	311.7%	18.9%	-8.1%	-14.9%
PER (x)	78.3	19.0	16.0	17.4	20.5
Free Cashflow ($M)	(29.7)	(79.0)	21.9	39.7	45.1
FCFPS (¢ps)	(8.5)	(22.6)	6.2	11.3	12.9
PFCFPS (x)	nm	nm	28.5	15.7	13.8
Enterprise Value ($M)	570.4	668.0	646.1	606.4	561.3
EV / EBITDA (x)	11.9	7.4	6.7	6.4	6.4
Payout ratio (%)	175.5	42.7	36.0	39.2	46.1
Dividends (¢ps)	4.0	4.0	4.0	4.0	4.0
Yield (%)	2.3	2.3	2.3	2.3	2.3

ASB – performance over one year



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Analysis

Austal Limited

Year end 30 June

MARKET DATA		
Recommendation		HOLD
Price	$	1.78
Price target (12-month)	$	1.80
52 week high / low	$	1.45 - 1.91
Market capitalisation (fully diluted)	$m	622.1
Shares on issue (basic)	no.	350.5
Options / rights	no.	0.0
Other equity	no.	0.0
Shares on issue (diluted)	no.	350.5

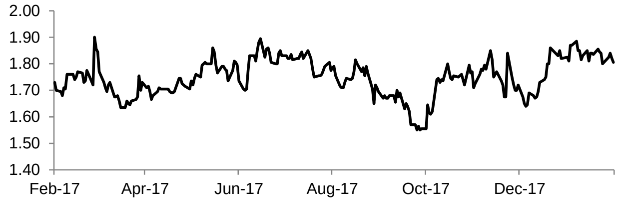
INVESTMENT FUNDAMENTALS		FY16A	FY17A	FY18F	FY19F	FY20F
Reported NPAT	$m	(101.3)	15.3	38.9	35.7	30.4
NPAT normalised	$m	7.9	32.7	38.9	35.7	30.4
Reported EPS (undiluted)	¢	(28.9)	4.4	11.1	10.2	8.7
EPS normalised (undiluted)	¢	2.3	9.3	11.1	10.2	8.7
....Growth	%	n/a	312%	19%	(8%)	-15%
PER normalised/undiluted	x	78.3	19.0	16.0	17.4	20.5
Operating cash flow per share	¢	0.0	(10.8)	22.2	21.5	19.7
Free cash flow per share	¢	(8.5)	(22.6)	6.2	11.3	12.9
Price to free cash flow per share	x	nm	nm	28.5	15.7	13.8
FCF yield	%	(4.8%)	(12.7%)	3.5%	6.4%	7.2%
Dividend	¢	4.0	4.0	4.0	4.0	4.0
Payout	%	175.5	42.7	36.0	39.2	46.1
Yield	%	2.3	2.3	2.3	2.3	2.3
Franking	%	100.0	100.0	100.0	100.0	100.0
Enterprise value	$m	570.4	668.0	646.1	606.4	561.3
EV/EBITDA	x	11.9	7.4	6.7	6.4	6.4
EV/EBIT	x	31.7	11.4	10.3	9.9	10.6
Price to book (NAV)	x	1.4	1.4	1.3	1.2	1.2
Price to NTA	x	1.5	1.5	1.4	1.3	1.3

KEY RATIOS		FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA margin	%	3.6%	6.9%	6.8%	7.7%	8.1%
EBIT margin	%	1.4%	4.5%	4.5%	5.0%	4.9%
NPAT margin	%	0.6%	2.5%	2.8%	2.9%	2.8%
ROE	%	1.7%	7.2%	8.1%	7.1%	5.8%
ROA	%	1.8%	6.1%	6.3%	6.2%	5.3%
Net tangible assets per share	¢	2.8	2.7	2.8	2.8	2.8
Net debt /(cash)	$m	(51.7)	45.9	24.0	(15.7)	(60.8)
Interest cover (EBIT / net interest)	x	(3.3)	(10.3)	(9.1)	(9.5)	(8.5)
Gearing (net debt / EBITDA)	x	nm	0.5	0.3	nm	nm
Leverage (net debt / (net debt + equity)	x	nm	0.1	0.0	nm	nm

DUPONT ANALYSIS		FY16A	FY17A	FY18F	FY19F	FY20F
Net Profit Margin	%	0.6	2.5	2.8	2.9	2.8
Asset Turnover	x	1	1.4	1.4	1.2	1.1
Return on Assets	%	1	3.4	3.9	3.6	3.1
Financial Leverage	x	2.2	2.1	2.1	2.0	1.9
Return on Equity	%	2	7.2	8.1	7.1	5.8

INTERIM SUMMARY		1H17A	2H17A	1H18F	2H18F
Total revenue	$M	649.2	660.9	625.8	777.7
Operating expenses	$M	(602.7)	(620.0)	(585.3)	(722.3)
EBITDA	$M	46.5	40.9	40.5	55.3
Depreciation & amortisation	$M	(15.3)	(16.5)	(16.5)	(16.5)
EBIT	$M	31.2	24.4	24.0	38.8
Net interest	$M	(3.0)	(3.2)	(3.4)	(3.5)
Pretax profit	$M	28.1	21.2	20.6	35.3
Tax expense	$M	(9.5)	(14.6)	(7.4)	(9.7)
Minorities/preference dividend	$M	0.0	0.0	0.0	0.0
Operating NPAT	$M	18.6	6.6	13.3	25.6
Significant items	$M	(9.3)	(8.1)	0.0	0.0
Reported NPAT	$M	9.3	(1.5)	13.3	25.6
Reported EPS (diluted)	¢	2.7	(0.4)	3.8	7.3
Normalised EPS	¢	5.3	1.9	3.8	7.3

12-MONTH RELATIVE SHARE PRICE PERFORMANCE



PROFIT AND LOSS		FY16A	FY17A	FY18F	FY19F	FY20F
Total revenue	$m	1,321.8	1,310.1	1,403.5	1,233.0	1,079.9
Costs (COGS & opex)	$m	(1,273.9)	(1,219.9)	(1,307.6)	(1,137.8)	(992.1)
EBITDA	$m	47.9	90.2	95.8	95.3	87.8
Depreciation & amortisation	$m	(29.9)	(31.5)	(33.0)	(33.8)	(34.8)
EBIT	$m	18.0	58.7	62.9	61.5	53.0
Net interest	$m	(5.5)	(5.7)	(6.9)	(6.5)	(6.2)
Non-operating income	$m	0.0	0.0	0.0	0.0	0.0
Pretax Profit	$m	12.5	53.0	56.0	55.0	46.8
Tax expense	$m	(4.5)	(20.3)	(17.1)	(19.2)	(16.4)
Minorities	$m	0.0	0.0	0.0	0.0	0.0
Operating NPAT	$m	7.9	32.7	38.9	35.7	30.4
Significant items	$m	(109.2)	(17.4)	0.0	0.0	0.0
Reported NPAT	$m	(101.3)	15.3	38.9	35.7	30.4

GROWTH PROFILE		FY16A	FY17A	FY18F	FY19F	FY20F
Operating revenue	%	n/a	(0.9)	7.1	(12.1)	(12.4)
EBITDA	%	n/a	(4.2)	7.2	(13.0)	(12.8)
EBIT	%	n/a	226.2	7.1	(2.2)	(13.8)
Operating NPAT	%	n/a	311.7	18.9	(8.1)	(14.9)
Normalised EPS	%	n/a	311.7	18.9	(8.1)	(14.9)
DPS	%	n/a	0.0	0.0	0.0	0.0

BALANCE SHEET		FY16A	FY17A	FY18F	FY19F	FY20F
Cash/(overdraft)	$m	224.3	150.5	172.3	212.1	257.1
Receivables	$m	128.3	100.4	107.6	94.5	82.8
Inventory	$m	109.0	170.4	168.4	148.0	129.6
Other	$m	8.5	10.4	10.4	10.4	10.4
Current	$m	470.1	431.7	458.7	464.9	479.9
Prop, plant & equip	$m	490.8	500.3	511.4	506.5	489.3
Other	$m	52.2	28.0	26.0	26.2	26.7
Non current	$m	543.0	528.3	537.5	532.6	516.0
Total assets	$m	1,013.1	960.0	996.2	997.6	995.9
Accounts Payable	$m	229.8	154.9	166.0	145.8	127.7
Borrowings	$m	172.6	196.4	196.4	196.4	196.4
Other	$m	153.2	151.8	152.0	151.9	151.9
Total liabilities	$m	555.6	503.1	514.3	494.0	475.9
Net assets	$m	457.6	456.9	481.8	503.6	519.9
Equity	$m	114.7	116.4	116.4	116.4	116.4
Retained earnings/other	$m	342.8	340.5	365.5	387.2	403.6
Shareholder's equity	$m	457.6	456.9	481.8	503.6	520.0

CASH FLOW		FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA	$m	47.9	90.2	95.8	95.3	87.8
Change in provisions	$m	0.0	0.0	0.0	0.0	0.0
Change in working capital	$m	213.0	(108.4)	5.9	13.4	12.0
Net interest	$m	(4.0)	(3.5)	(6.9)	(6.5)	(6.2)
Tax paid	$m	(4.8)	12.2	(17.1)	(26.9)	(24.5)
Other	$m	(252.0)	(28.4)	0.0	0.0	0.0
Operating cash flow	$m	0.0	(37.9)	77.8	75.2	69.1
Stay in business capital expenditure	$m	(12.8)	(9.2)	(41.9)	(21.5)	(10.0)
Acquisitions/divestment/other	$m	(12.2)	(44.3)	0.0	0.0	0.0
Investing cash flow	$m	(25.0)	(53.5)	(41.9)	(21.5)	(10.0)
Equity	$m	0.0	0.0	0.0	0.0	0.0
Increase / (decrease) in borrowings	$m	11.1	24.6	0.0	0.0	0.0
Dividend/other	$m	(15.8)	(12.3)	(14.0)	(14.0)	(14.0)
Financing cash flow	$m	(4.7)	12.4	(14.0)	(14.0)	(14.0)
Free cash flow	$m	(29.7)	(79.0)	21.9	39.7	45.1

Source: Petra Capital

Uncertainty to overhang for now

Our investment view reflects the following assumptions:

- Littoral Combat Ship (LCS) construction no. 3 – 12, to be shared (50:50) with co-contractor, Civmec (note: this assumption is likely to change however for simplicity sake we assume an equal share, pending further updates).
- The Offshore Patrol Vessel (OPV) Program is secured by ASB this calendar year, at a construction contract value of c.A$1B.
- That ASB is not successful in securing a construction role on the Future Frigate program.
- That ASB secures an incremental c.A$65M pa in Commercial construction work through FY23.

For investors, we expect the share price to remain range bound until more clarity is provided on both the OPV project and Future Frigate. We remain on Hold as a result, with our target price falling 5c to $1.80 (as discussed below).

Three's a crowd; but not a fiasco

While the details of the offshore Patrol Vessel (OPV) contract (awarded Nov-17) remain to be negotiated between the winning designer Lusenne, and co-contractors, it is the fact that these remain outstanding and are now subject to internal bidding tensions between joint construction partners Australian Submarine Corporation (ASC), ASB and Civmec that cause us some concern over future margin potential form this specific project.

The project is complex, but further complicated by the fact there are three builders across two shipyards; ASC will construct the first two vessels in Adelaide while ASB and Civmec will construct vessels 3-12 in WA. The share price reaction following the announcement suggests that the market is unsure of how interpret the impacts of the multi-faceted construction approach; this is likely to remain until we have more certainty.

Contract details expected mid-February

The Defence Department ("Defence") has stated that OPV negotiations will be completed by mid-February at the latest. This is a tight timeframe in our view. A great deal of the work issued by Defence (generally) is fixed price, and there is much to be negotiated over who takes what work, how that is priced, how losses are divided amongst the parties, and importantly, how 'learnings' from project implementation are shared in order to improve construction timeframes and build quality.

The first OPV is due to be delivered in H120. ASC (contractor for the first two vessels in Adelaide) will need to start work almost straight away to hit this deadline and this in itself adds a further layer of risk. While specific details of how the project partnership will work, it is difficult for us to capture and value the upside at this stage. We think this can cap the upside for now.

Henderson utilisation increase over a long period is key for future group profitability

Nonetheless, what does give us greater optimism, is that the facilities at the Henderson shipyard will move to over 50% utilised as a result, with the long duration OPV programme underpinning activity on the site for over 15 years. One benefit that should not be overlooked is to future project wins, as the higher utilisation of the yards will create greater scale efficiencies, allocating fixed costs amongst greater projects.

Thus, any future project awards should, in theory, drop through at higher margins and profitability. This is potentially of greater benefit than the OPV project taken in isolation and should not be overlooked by investors.

Next catalyst: Future Frigate (mid 2018)

Post H118 results, attention will likely turn towards the Future Frigate programme, with a winner to be announced mid-2018. In our view, timely construction of the Future Frigate programme could require Government to contemplate a modularised construction approach with a shared workload across more than one builder. Should ASB be selected as a sub-contractor, we also caution that the quantum of work outsourced may not need to be significant. This may especially be the case if an international prime contractor is selected.

Government programme to underpin defence exports is a positive step

The Australian Government recently (29/1) committed to the formation of a $3.8bn fund to support defence industry exports. This fills a funding gap where domestic defence contractors have been unable to obtain (private sector) funding. Investment into defence companies, jobs and promoting a highly skilled, local defence industry workforce will be key to promoting Australia as an exporter of defence technology (currently 20th, but seeking to push into the top 10). This comes in addition to Government budget policy to increase defence spending by an additional $30bn in the five years to 2021. It is the investment in improved supply chain and domestic staffing which would be of greatest benefit to Austal in the coming years, in our view, ensuring ongoing availability of a skilled workforce.

Nonetheless, we are also aware that political decisions can, and do change very quickly, while priorities and budget decisions may change if there is a change in Government.

It's not all about defence

The Commercial Ferry business has continued to gain traction, recently (28/12) being awarded another contract for a $30m vessel. In the past 12 months, the company has added 8 vessels worth $380m in contracted revenue. This will be an important area for ASB moving forward, given its positive mix effect on group EBIT margins. We believe Management will be more active here looking ahead.

Changes to forecasts

Broadly, we make the following changes to our forecasts:

- We had originally factored in a win for the entire OPV project. We now remove OPV 1 and 2 from our modelling, with start date for OPV 3 now H220.
- We split the OPV revenues 50:50 with co-contractor Civmec (i.e. c$42m per vessel). We stress that at this stage, this is our view and Management may update the market otherwise.
- We make no changes to margins over the life of the OPV project. Longer term, the upside margin potential may be tempered by the co-contractor relationship. We stress that at this stage, this is our view and Management may update the market otherwise.
- We moderate the capex and working capital assumptions for the project, delaying the ramp up until FY19, but also reducing capex in light of Management's comments that the Australian Government will provide the bulk of capital expenditures required to complete the project.

Figure 1: Changes to forecasts, FY18 – 20F

	FY18F			FY19F			FY20F		
	Old	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Revenue	1415.9	1,403.5	(0.9)	1,303.9	1,233.0	(5.4)	1,157.0	1,079.9	(6.7)
EBITDA	97.1	95.8	(1.3)	102.8	95.3	(7.3)	96.3	87.8	(8.8)
EBIT	64.1	62.9	(1.9)	69.0	61.5	(10.9)	61.5	53.0	(13.8)
NPAT (reported)	40.1	38.9	(3.0)	40.6	35.7	(12.1)	35.9	30.4	(15.3)
EPS (underlying)	11.5	11.1	(3.2)	11.6	10.2	(12.3)	10.3	8.7	(15.6)
EPS (reported)	11.5	11.1	(3.2)	11.6	10.2	(12.3)	10.3	8.7	(15.6)
DPS	4	4.0	0.0	4.0	4.0	0.0	4.0	4.0	0.0

Source: Petra Capital estimates

Valuation: DCF based price target falls 5c to $1.80

As a result of forecast changes and the roll forward our DCF, our DCF derived PT falls 5c to $1.80.

Figure 2: DCF calculations FY18F – FY25F (A$m)

	FY18F	FY19F	FY20F	FY21F	FY22F	FY23F	FY24F	FY25F
EBIT	62.9	61.5	53.0	46.4	34.6	28.2	18.5	18.8
Tax at standard rate	(17.1)	(19.2)	(16.4)	(14.2)	(10.3)	(8.2)	(4.6)	(4.7)
Post-tax EBIT	45.8	42.2	36.6	32.2	24.4	20.1	13.9	14.1
D&A	(33.0)	(33.8)	(34.8)	(34.8)	(34.8)	(34.8)	(34.8)	(34.8)
Post-tax cash flow	78.8	76.0	71.4	67.0	59.2	54.9	48.7	48.9
Less capex	(41.9)	(21.5)	(10.0)	(7.3)	(5.0)	(4.1)	(3.2)	(3.1)
Less working capital	5.9	13.4	12.0	23.3	19.6	7.3	8.3	0.4
Provisions/other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Acquisitions/disposals	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free cash flow	**42.7**	**67.9**	**73.4**	**82.9**	**73.8**	**58.0**	**53.8**	**46.2**
Discount coefficient	0.4	1.4	2.4	3.4	4.4	5.4	6.4	7.4
Discounted cash flow	**41.1**	**59.4**	**58.3**	**59.9**	**48.4**	**34.7**	**29.2**	**22.8**

Sum of discount streams	394.4	**CAPM**	
Terminal growth	3.0%	Risk free rate	5.25%
Future value into perpetuity	693.4	Equity beta	1.25
NPV of terminal value	282.8	Equity risk premium	6.00%
PV of cash flows	**677.1**		**12.8%**
		WACC	
PLUS: Value of investments	0.0	Debt	30%
PLUS: Value of tax losses	0.0	Equity	70%
LESS: Minority interests	0.0	Interest rate	5.0%
LESS: Net debt	(45.9)	Tax rate	30%
Equity value	**631.3**		**10.0%**
Ordinary shares	350.5		
Value per share (A$)	**1.80**		

Source: Petra Capital estimates

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