Hartleys

WA Industrials: Marine Design & Construction

AUSTAL LIMITED (ASB)

1H18 result roughly in line. Mixed news on contracts.

Austal Limited ("Austal", "ASB", "Company") reported its 1H18 result which was very marginally below what we expected (except at the tax line). We have downgraded our FY18 revenue forecast by 1% and EBIT by 3%. Due to a change in the US Corporate Tax rate ASB recorded a $7m non-cash credit in 1H18. We have lowered our marginal tax rate going forward. Overall 1H18 was a solid period for ASB, nine ferries were ordered worth $380m, with an overall order book now standing at circa A$3.4bn. ASB ended the period with a strong balance sheet (adjusted net debt of $11m and $112m of cash, versus $13m and $153.5m in cash respectively 12 months ago). Final cash payments from EPF9 and perhaps LCS14 should also hit the bank account in the next six months.

1H18 Result - Solid result with some overhangs

Revenue overall was roughly in line with our expectations, with Australia and the Philippines (on the back of the continued strength in commercial orders) compensating for lower US sustainment revenue. However, Australian margins were lower than we expected (at 0% EBIT) which negated overall the expected recovery in US shipbuilding to 7.6% (up from 6.6%). The award of the Australian Government OPV contract to designer Lürssen, rather than the ASB backed Fassmer, was obviously a disappointment. Despite this, only the first two OPVs will be built at the Osborne Naval Shipyard in South Australia by ASC, with construction starting this year. The remaining 10 will be constructed at the Henderson Maritime Precinct in WA from 2020. It was also disappointing that the US Government awarded five $15m design contracts for their Frigate programme, increasing the level of competition.

Outlook – 2H18 and Beyond

The Company has maintained its revenue guidance for the full year of A$1.3-1.4bn and continues to expect US shipbuilding EBIT margins to be in the 6-8% range. In Australia, PPB will generate circa 20% revenue growth into FY19. In the Philippines, throughput will approximately double from FY18 to FY19 with the growth and delivery of the commercial order book. Overall commercial revenue will increase circa 50% in FY19 (total commercial order book stands at $435m). Having backed the losing designer in the US Governments OPV award, ASB's Henderson yard will still build the 10 vessels to be constructed in WA. Negotiations are currently underway and we should find out in 2H18 the likely work share net to ASB. Major news flow in 2H18 will be focused on 3 key areas; i) Further commercial wins ii) Finalisation of OPV discussions with Lürssen iii) Frigates for the Royal Australian Navy, down select to 1 bidder is expected in CY18.

Neutral recommendation maintained – minor price adjustment

We have made some minor changes to forward earnings and remain marginally ahead of consensus for FY18 and FY19. We value ASB on the basis of our NPV10 of all future work and close to parity with the multiples of the ASX 300 Industrials sector (ex-BIP). The average multiple for this sector continues to increase (up between 20-30% over the past year) and this is behind the upgrade in our 12-month forward target price to $2.10 per share.

ASB.asx
Neutral

6 Mar 2018

Share Price:	$1.79
Valuation:	$2.10
12mth price target:	$2.10

Brief Business Description:
Commercial and naval marine design and construction.

Hartleys Brief Investment Conclusion
Austal (ASB) generates the majority of its earnings from US naval contracts. Additional earnings are derived from commercial vessel construction and marine services

Chairman & CEO:
John Rothwell AO
David Singleton

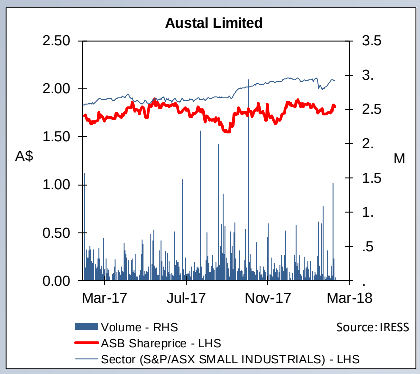
Top Shareholders:
Allan Gray Australia Pty Ltd 18.6%

Company Address:
100 Clarence Beach Road
Henderson WA

Issued Capital:	349.4m
- fully diluted	359.9m
Market Cap:	$623.7m
- fully diluted	$623.7m
Net Debt (FY 18e)	$3.8m

		FY16a	FY17a	FY18e
Op Cash Flw		102.1	-37.9	75.2
Free Cash Flw		77.1	-91.4	56.1
NPAT* (A$m)	-	**71.7**	**32.7**	**47.9**
EPS ($, bas)	-	20.5	9.3	13.7
P/E (basic)		-8.7x	19.1x	13.1x
P/E (diluted)		-9.0x	19.7x	13.4x
EV / EBITDA		-7.8x	6.8x	6.2x
DPS (cps)		4.0	4.0	4.0
Dividend Yield		2.2%	2.2%	2.2%
N.D. / equity		-11%	10%	1%

Source: Hartleys Research. * normalised



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SUMMARY MODEL

Austal Limited (ASB)

Recommendation: Neutral

Company Information		
Date	6 Mar 2018	100 Clarence Beach Road
Share Price	$1.79	Henderson WA
52 Week High-Low	$2.02 - $1.495	Australia, 6166
Market Cap ($m)	$623.7	D: +61 8 6414 4010
Enterprise Value ($m)	$611.7	www.austal.com
Ordinary Shares	349.4	
Fully Diluted Shares	359.9	

Valuation					
S&P/ASX Industrials	FY19 Multiple	ASX Comps	Target Multiple	Wgt.%	Tgt Price
EV/EBIT	8.8x	12.3x	10.8x	10%	2.12
EV/EBITDA	5.9x	8.0x	7.0x	25%	2.07
Earnings	14.1x	18.7x	16.5x	30%	2.14
Div Yield	2.8%	3.1%	2.7%	0%	1.83
NPV				35%	2.09
Valuation					**$2.10**
upside from current					*18%*
P / E (6/18F) at price target					15.8x
P / E (6/19F) at price target					*16.6x*
EV / EBITDA (6/18F) at price target					*7.9x*
EV / EBIT (6/18F) at price target					*12.4x*
Dividend Yield (6/18F) at price target					1.9%

Multiples (S/price at $1.79)	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
P / E (reported, basic weighted)	15.0x	11.6x	-7.4x	40.5x	13.0x	13.7x
P / E (normalised, dil. weighted)	14.8x	13.8x	-8.7x	19.1x	13.1x	13.7x
P / E (mkt cap / norm. NPAT)	15.0x	13.9x	-8.7x	19.1x	13.0x	13.7x
P / E (fully diluted mkt cap / norm. NF	15.4x	14.3x	-9.0x	19.7x	13.4x	14.1x
Dividend Yield	0.0%	2.2%	0.0x	2.2%	2.2%	2.8%
Group Free Cash Flow (f.c.f) / EV	8.9%	13.5%	0.1x	-14.7%	9.2%	7.8%
Equity f.c.f. / Mkt Cap	-5.6%	8.2%	0.1x	-10.5%	7.4%	6.0%
Norm f.c.f. / Mkt cap	-5.6%	8.2%	0.1x	-10.5%	7.4%	6.0%
Mkt cap / operating cash flow	15.0x	5.6x	6.1x	-16.5x	8.3x	9.3x
EV/EBITDA multiple	6.9x	6.3x	-7.8x	6.8x	6.2x	5.9x
EV/EBIT multiple	9.4x	8.4x	-5.6x	10.4x	9.8x	8.8x
Price / Book Value	1.5x	1.3x	1.4x	1.4x	1.3x	1.2x
Price / NTA	1.5x	1.3x	1.5x	1.4x	1.3x	1.2x
Price / FCF	11.4x	7.5x	10.2x	-6.9x	11.2x	13.2x

Ratios	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
Return period end Equity	7.4%	10.4%	-18.4%	3.4%	9.8%	8.7%
ROA	4.5%	4.5%	-6.9%	3.3%	4.9%	4.6%
ND / ND + Equity	15.8%	3.1%	-12.7%	9.1%	0.8%	-6.0%
ND / Equity	18.7%	3.2%	-11.3%	10.0%	0.8%	-5.7%
Net Interest Cover (EBIT)	7.8	17.8	-19.7	10.4	9.3	11.4
ROIC	6.4%	6.3%	-12.8%	5.0%	7.4%	7.1%

Free Cash Flow Analysis ($m)	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
Net Operating Cash Flow	41.6	110.4	102.1	-37.9	75.2	67.2
Capex (Reported)	12.7	-28.1	-40.9	-52.0	-19.1	-19.7
Group Free Cash Flow (rep'ted)	54.4	82.3	61.2	-89.9	56.1	47.5
Fixed Debt Repayments	-89.3	-31.1	11.1	24.6	-10.0	-10.0
Equity Free Cash Flow (rep'ted)	**-35.0**	**51.2**	**72.2**	**-65.2**	**46.1**	**37.5**
HP Lease Capex (non-cash)	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow (normalised)	-35.0	51.2	72.2	-65.2	46.1	37.5
Capex (inc HP) / depreciation	-54%	116%	137%	165%	53%	57%

Share Data	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
Ord Issued shares (m)	346.5	346.9	349.4	349.5	350.5	351.5
growth	0.1%	0.2%	0.8%	0.7%	0.3%	0.6%
Weighted ave shares (m)	267.4	346.5	348.0	348.2	349.9	350.5
growth	0.8%	30.7%	30.1%	0.5%	0.6%	0.7%
Diluted shares wgted (m)	346.2	346.9	349.4	349.5	350.5	351.5
growth	87.8%	0.2%	0.9%	0.7%	0.3%	0.6%

Options & Rights

Year Expires	Number	% ord
28-Sep-17	1,925,000	0.5%
20-Oct-18	1,715,000	0.5%
Various	709,018	0.2%
5-Oct-18	1,418,036	0.4%
Perf. Rights	4,775,438	1.3%
TOTAL	**10,542,492**	**2.9%**

Directors & Senior Management	
John Rothwell AO	Non-Executive Chairman
David Singleton	Managing Director
Giles Everist	Independent Director
Jim McDowell	Independent Director

Substantial Shareholders	%
Allan Gray Australia Pty Ltd	18.6%

Profit & Loss ($m)	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
Australia - Divisional						
Revenue	153.9	211.8	187.0	113.7	191.7	232.1
EBIT	16.7	31.8	6.7	-2.1	2.9	4.4
EBIT Margin	10.8%	15.0%	3.6%	-1.8%	1.5%	1.9%
USA - Divisional						
Revenue	933.6	1119.7	1133.1	1172.1	1077.2	1159.4
EBIT	61.7	58.4	-90.6	78.5	73.5	79.9
EBIT Margin	6.6%	5.2%	-8.0%	6.7%	6.8%	6.9%
Philippines - Divisional						
Revenue	32.8	38.7	33.9	33.8	52.4	65.5
EBIT	2.7	1.0	-3.7	0.3	-1.3	-1.6
EBIT Margin	8.3%	2.6%	-10.9%	0.9%	-2.5%	-2.5%
Total Revenue	**1,122.8**	**1,414.9**	**1,340.0**	**1,308.6**	**1,308.0**	**1,443.8**
growth	*24.9%*	*26.0%*	-5.3%	*-2.3%*	*0.0%*	10.4%
Segment EBITDA	101.6	112.4	-60.8	106.3	108.7	115.2
Overhead	-12.5	-14.9	-17.6	-16.1	-10.4	-11.1
- % of sales	-1.1%	-1.1%	-1.3%	-1.2%	-0.8%	-0.8%
EBITDA	**89.1**	**97.5**	**-78.5**	**90.2**	**98.3**	**104.0**
margin	**7.9%**	**6.9%**	**-5.9%**	**6.9%**	**7.5%**	**7.2%**
Depreciation/Amortisation	-23.8	-24.3	-29.9	-31.5	-35.7	-34.5
EBIT	65.3	73.2	-108.4	58.7	62.6	69.5
EBIT / Sales	5.8%	5.2%	-8.1%	4.5%	4.8%	4.8%
Net Interest	-8.4	-4.1	-5.5	-5.7	-6.7	-6.1
Profit Before Tax	**56.9**	**69.1**	**-113.9**	**53.0**	**55.9**	**63.4**
- margin	**5.1%**	**4.9%**	**-8.5%**	**4.0%**	**4.3%**	**4.4%**
Normalised Tax	-15.3	-24.1	42.2	-20.3	-8.0	-17.8
Effective Tax Rate	26.9%	34.9%	37.0%	38.3%	14.3%	28.0%
NPAT Pre Minorities	41.6	45.0	-71.7	32.7	47.9	45.7
Minorities	0.0	0.0	0.0	0.0	1.0	2.0
Normalised NPAT to equity	**41.6**	**45.0**	**-71.7**	**32.7**	**47.9**	**45.7**
Normalised tax rate	-27%	-35%	-37%	-38%	-27%	-28%
Norm. Net Profit / Sales	**3.7%**	**3.2%**	**-5.3%**	**2.5%**	**3.7%**	**3.2%**
Abnormals / discontinued	-9.8	8.2	-12.6	-17.3	0.0	0.0
Reported Profit to equity	31.9	53.2	-84.3	15.4	47.9	45.7
Reported EPS (basic, w'ghted)	11.9	15.3	-24.2	4.4	13.7	13.0
Normalised EPS (dil, wghtd)	12.0	13.0	-20.5	9.3	13.7	13.0
Normalised EPS (full. diluted)	11.6	12.5	-19.9	9.1	13.3	12.7
EPS (full dil) Growth %	***16.5%***	***8.1%***	***-259.3%***	***-145.5%***	***46.7%***	***-4.7%***
DPS (cps)	**0.0**	**4.0**	**4.0**	**4.0**	**4.0**	**5.0**
Payout Ratio	0.0%	26.1%	-16.5%	90.7%	29.2%	38.4%

Cashflow Statement ($m)	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
EBITDA	89.1	97.5	-78.5	90.2	98.3	104.0
Working Capital Change	6.5	19.8	213.0	-108.4	-8.5	-13.0
Net interest Paid	-4.1	-6.6	-5.7	-6.7	-6.1	-5.3
Tax Paid	-15.9	-18.5	42.2	-20.3	-8.0	-17.8
Other	-29.6	15.8	-68.1	6.2	0.0	0.0
Net Operating Cash Flow	**41.6**	**110.4**	**102.1**	**-37.9**	**75.2**	**67.2**
Capital Expenditure	12.7	-28.1	-40.9	-52.0	-19.1	-19.7
Asset Sales	0.0	6.3	0.0	0.0	1.0	2.0
Other (inc Investments)	6.2	0.0	15.9	-1.5	0.0	0.0
Net Investing Cash Flow	**19.0**	**-21.8**	**-25.0**	**-53.5**	**-19.1**	**-19.7**
Proceeds from Equity Issues	0.0	0.0	0.0	0.0	0.0	0.0
Net Change in Debt & Leases	-89.3	-31.1	11.1	24.6	-10.0	-10.0
Dividends Paid	0.0	-3.5	-15.8	-12.3	-14.0	-14.0
Net Financing Cash Flow	**-89.3**	**-34.6**	**-4.7**	**12.4**	**-24.0**	**-24.0**
Movement in Cash	-28.7	54.0	72.4	-79.0	32.1	23.5
HP Lease Capex (non-cash)	0.0	0.0	0.0	0.0	0.0	0.0

Balance Sheet ($m)	6/14A	6/15A	6/16A	6/17A	6/18F	6/19F
Cash	74.4	138.4	224.3	150.5	182.6	206.1
Receivables	95.8	104.3	128.3	100.4	107.5	118.7
Inventories	328.1	339.7	109.0	170.4	169.4	187.6
Other	19.2	16.5	8.5	10.4	10.4	10.4
Total Current Assets	**517.5**	**598.9**	**470.1**	**431.7**	**469.8**	**522.7**
Property, Plant & Equipment	366.5	442.5	490.8	500.3	483.7	468.8
Intangibles	9.0	9.0	35.0	5.6	5.6	5.6
Other	18.2	20.4	17.3	22.4	22.4	22.4
Total Non Current Assets	**393.8**	**471.9**	**543.0**	**528.3**	**511.6**	**496.8**
Total Assets	**911.3**	**1,070.9**	**1,013.1**	**960.0**	**981.5**	**1,019.5**
Accounts Payable	183.6	223.5	229.8	154.9	152.5	168.8
Interest Bearing Liabilities	13.2	146.9	2.5	9.9	9.9	9.9
Other	79.3	92.1	74.4	74.1	74.1	74.1
Total Current Liabilities	**276.0**	**462.5**	**306.8**	**238.9**	**236.5**	**252.8**
Interest Bearing Liabilities	142.3	7.7	170.1	186.5	176.5	166.5
Deferred Tax Liability	49.9	63.7	72.0	62.9	62.9	62.9
Other	9.9	24.6	6.8	14.8	14.8	14.8
Total Non Current Liabilities	**202.0**	**96.0**	**248.8**	**264.2**	**254.2**	**244.2**
Total Liabilities	**478.1**	**558.5**	**555.6**	**503.1**	**490.6**	**497.0**
Net Assets	**433.2**	**512.4**	**457.6**	**456.9**	**490.8**	**522.5**
Net Asset Value / Share ($)	1.20	1.42	1.27	1.27	1.36	1.45
NTA / Share ($)	1.18	1.40	1.17	1.25	1.35	1.44
Net Debt (net cash)	81.0	16.1	-51.7	45.9	3.8	-29.7

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Last Earnings Estimate Changes:
06-March-2018

Sources: IRESS, Company Information, Hartleys Research

HIGHLIGHTS

ASB reported its 1H18 result which was very marginally weaker what we expected (except at the tax line which was considerably below the charge we expected). This was due to a change in the US Corporate Tax rate, and ASB recorded a $7m non-cash credit in 1H18. We have lowered our marginal tax rate going forward. Overall, we have downgraded our FY18 revenue forecast by 1% and EBIT by 3%.

Fig. 1: Earnings Changes

A$ m	FY15 Act	FY17 Act	FY17 Act	FY18 Old	FY18 New	FY18 % diff	FY19 Old	FY19 New	FY19 % diff
Revenue	**1,415**	**1,340**	**1,309**	**1,315**	**1,308**	**-1%**	**1,470**	**1,444**	**-2%**
USA	1,120	1,133	1,172	1,124	1,077	-4%	1,222	1,159	-5%
Australia	212	187	114	168	192	14%	222	232	5%
Philippines	31	34	34	35	52	51%	36	65	80%
Other	45	-14	-11	-11	-13	20%	-11	-13	20%
EBITDA -Divisional	**97**	-78	**90**	**96**	**98**	**2%**	**112**	**104**	**-7%**
USA	77	-66	105	104	104	0%	113	109	-4%
Australia	33	8	-1	9	5	-50%	16	6	-61%
Philippines	2	-2	2	0	0	-262%	1	0	-98%
Other	-15	-18	-16	-17	-10	-39%	-18	-11	-38%
EBIT - Divisional	**73.2**	**-108**	**59**	**65**	**63**	**-3%**	**81**	**69**	**-14%**
USA	58	-91	79	78	74	-5%	87	80	-9%
Australia	32	7	-2	8	3	-63%	14	4	-69%
Philippines	1	-4	0	-2	-1	-24%	-1	-2	80%
Other	-18	-21	-18	-19	-13	-33%	-20	-13	-33%
NPAT	**45.0**	**-72**	**32.7**	**40.1**	**47.9**	**19%**	**51.6**	**45.7**	**-12%**

Source: Hartleys Research

Revenue overall was roughly in line with our expectations, with Australia and the Philippines (on the back of the continued strength in commercial orders) compensating for lower US sustainment (support) revenue. However, Australian margins were lower than we expected (at 0% EBIT) which negated overall the expected recovery in US shipbuilding to 7.6% (up from 6.6%).

Fig. 2: Segment Breakdown

$m	Concept	Ships	Systems	Support	Other	Total
USA	Revenue	$ 416.4	$ 81.6	$ 59.7	$ -	$ 557.7
	EBIT	31.7	2.1	2.6	(0.3)	36.2
	EBIT Margin %	7.6%	2.6%	4.4%	-	6.5%
Australia	Revenue	$ 44.4	$ -	$ 36.5	$ -	$ 80.8
	EBIT	(3.1)	-	3.1	-	(0.0)
	EBIT Margin %	(7.0%)	-	8.5%	-	(0.0%)
Philippines	Revenue	$ 22.6	$ -	$ -	$ -	$ 22.6
	EBIT	(1.1)	-	-	-	(1.1)
	EBIT Margin %	(4.8%)	-	-	-	(4.8%)

Source: Hartleys Research

Overall 1H18 was a solid period for ASB, nine ferries were ordered worth $380m, with an overall order book now standing at circa A$3.4bn. ASB ended the period with a strong balance sheet (adjusted net debt of $11m and $112m of cash, versus $13m and $153.5m in cash respectively 12 months ago). Final cash payments from EPF9 and perhaps LCS14 should also hit the bank account in the next six months.

Fig. 3: Half Year Summary

A$ m	FY16			FY17			FY18 F			Current Period	
	1H	2H	FY	1H	2H	FY	1H	2H	FY	HoH	YoY
Revenue	747	593	1,340	649	659	1,309	653	655	1,308	-1.0%	0.6%
EBITDA	42	(120)	(78)	47	44	90	46	52	98	6.3%	0.0%
Margin %	*5.6%*	*-20.3%*	*-5.9%*	*7.2%*	*6.6%*	*6.9%*	*7.1%*	*7.9%*	*7.5%*	*49 bps*	*-4 bps*
D&A	(13)	(17)	(30)	(15)	(16)	(32)	(17)	(18)	(36)	6.1%	13.2%
EBIT	29	(137)	(108)	31	28	59	29	33	63	6.0%	-6.2%
Margin %	*3.88%*	*-23.18%*	*-8.09%*	*4.80%*	*4.18%*	*4.49%*	*4.48%*	*5.09%*	*4.78%*	*29 bps*	*-32 bps*
Interest Expense	(3)	(4)	(7)	(3)	(3)	(6)	(4)	(3)	(7)	57.7%	37.2%
PBT	27	(141)	(114)	28	25	53	25	31	56	0.9%	-10.9%
Tax	(10)	52	42	(10)	(11)	(20)	1	(8)	(8)	-104.7%	-105.3%
Tax rate %	*37.2%*	*37.1%*	*37.0%*	*33.8%*	*43.4%*	*38.3%*	*-2.0%*	*27.5%*	*14.3%*	*-4543 bps*	*-3585 bps*
NPAT	17	(101)	(84)	19	14	33	26	22	48	82.0%	37.5%

Source: Hartleys Research

The Company has maintained its revenue guidance for the full year of A$1.3-1.4bn and continues to expect US shipbuilding EBIT margins to be in the 6-8% range. Our estimates in general are slightly ahead of consensus for FY18 and FY19.

Fig. 4: FY18 Hartleys Estimates vs Guidance

	FY18			FY19		
	Consensus	Hartleys	Variation	Consensus	Hartleys	Variation
Revenue	1,357.7	1,308.0	-3.7%	1,296.0	1,443.8	11.4%
EBITDA	95.7	98.3	2.8%	101.0	104.0	3.0%
EBIT	60.7	62.6	3.1%	66.2	69.5	5.0%
PBT	53.6	55.9	4.3%	60.4	63.4	4.9%
NPAT	44.1	47.9	8.5%	45.2	45.7	0.9%

Source: Hartleys Research

News flow in 1H18 was mixed. The highlight was the continued strength in the commercial market. ASB achieved another $380m of new commercial orders in 1H18, leaving the total commercial order book at $435m (with ASB's unique Trimaran hull a key differentiator). Overall commercial revenue is expected to increase circa 50% in FY2019. Key commercial contracts include;

Australia;

- Mols (~$90m, 109m vehicle / passenger ferry)

Over 50% complete and on schedule.

Philippines;

- FRS ($22m, 56m vessel).

Ferry will be delivered in 2HFY18.

- VS Grand Tours ($5m, 30m ferry)

Construction has just commenced.

- Fjord Line (~ $108 m, 109 m vehicle passenger ferry).

First metal was cut February 2018.

- Braveline ($44m, 2 x 50 m ferries)

Construction will commence in 2HFY18.

- Aremiti ferry ($30m, 49m ferry)
- Construction will commence in 2HFY18.

China;

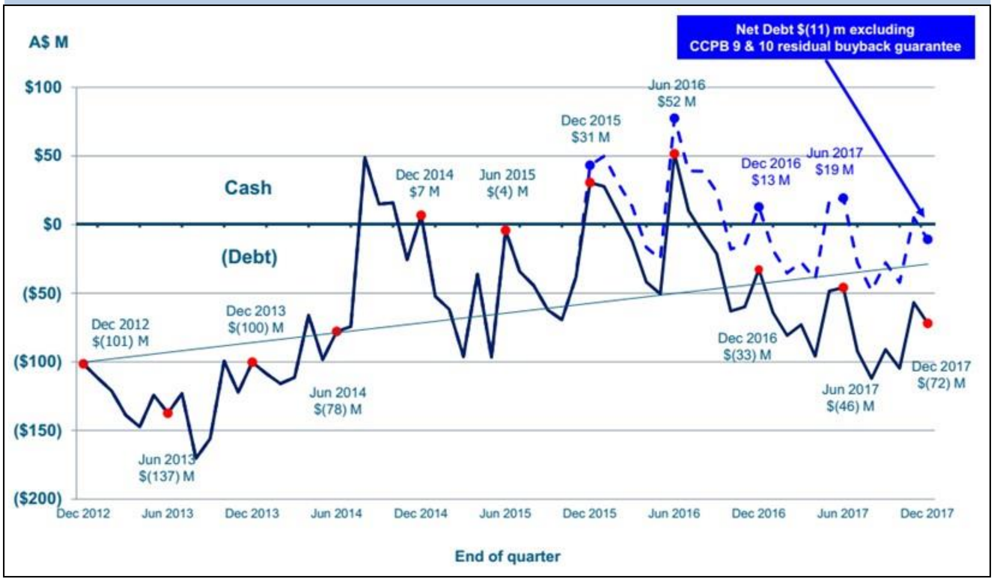
- 6 x ~ $5-6 m, 35m high-speed catamarans in Aulong Joint Venture (ASB 40%).

The award of the Australian Government OPV contract to designer Lürssen, rather than the ASB backed Fassmer, was obviously a disappointment. Despite this, only the first two OPVs will be built at the Osborne Naval Shipyard in South Australia by ASC, with construction starting this year. The remaining 10 will be constructed at the Henderson Maritime Precinct in WA from 2020. ASB was introduced to the project to build 10 of the 12 OPVs, despite Lürssen only partnering with ASC and Civmec. The government has confirmed Civmec will provide the steel from Australian suppliers for all 12 OPVs.

It was also disappointing that the US Government awarded 'five' $15m design contracts for their Frigate programme. Fincantieri Marine Group, General Dynamics and Huntington Ingalls have been added to the shortlist along with ASB and Lockheed Martin, increasing the level of competition for this crucial award.

This balance sheet capacity puts the Company in a strong position to expand capacity if and when it is required. As an example, they intend to spend circa US$30m on increasing throughput capacity in the Philippines where they require throughout in excess of $50m per annum (historic average $35m p.a.) to service the booming commercial market.

Fig. 5: Net Debt / Cash



Source: ASB

Major news flow in 2H18 will be focused on 3 key areas;

i) Further commercial wins,

ii) Finalisation of OPV discussions with Lürssen,

iii) Frigates for the Royal Australian Navy, down select to 1 bidder is expected in early CY18.

RECOMMENDATION & RISKS

INVESTMENT THESIS & RECOMMENDATION

Austal's achievements in establishing itself as a primary supplier to both the Australian Navy (and especially) and US Navy is quite simply a tremendous achievement.

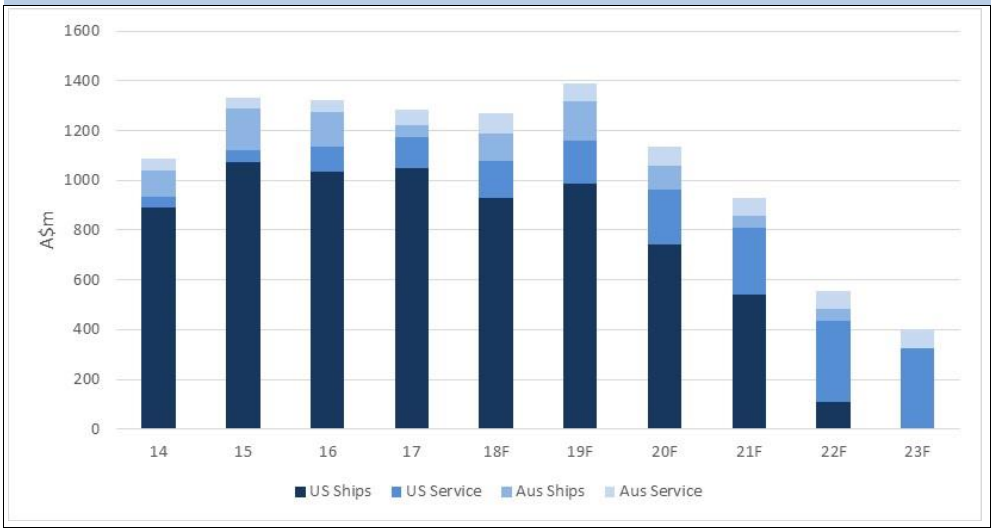
However, it has not been without its teething problems and the volatility in the share price over the past five years reflects that (a low of 52c in late 2012 to a high of $2.43ps in late 2015).

The Company is on the verge of taking another leap forward. Winning a substantial portion of the Royal Australian Navy's Future Frigates Programme will underpin the Company's Australian business for decades to come and further confirm its credentials in steel hull ship building, important to participate in tenders for large vessels globally going forward.

However, it is the US Navy's LCS/Frigate contract that will likely determine the extent of upside for ASB in the near future. If the Company secures at least a portion of this extension contract, it will along with the Australian Future Frigates contract position them reputationally to compete for a larger number of global contracts against the major defence contractors.

ASB to maintain utilisation of their existing three yards at close to capacity has to secure additional contracts in the next 12-18 months as highlighted in the chart below.

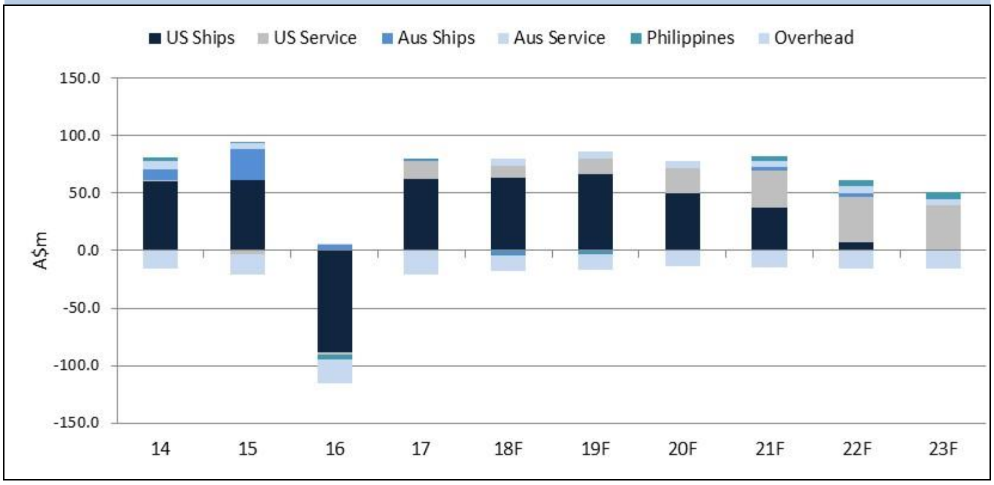
Fig. 6: Revenue Outlook – Existing Backlog



Source: Hartleys Research

Sustainment revenue going forward will provide a significant high margin source of income both in the US and Australia, and would naturally increase further as more Naval vessels are built. This is a significant change for ASB versus the past and will assist in smoothing out earnings going forward.

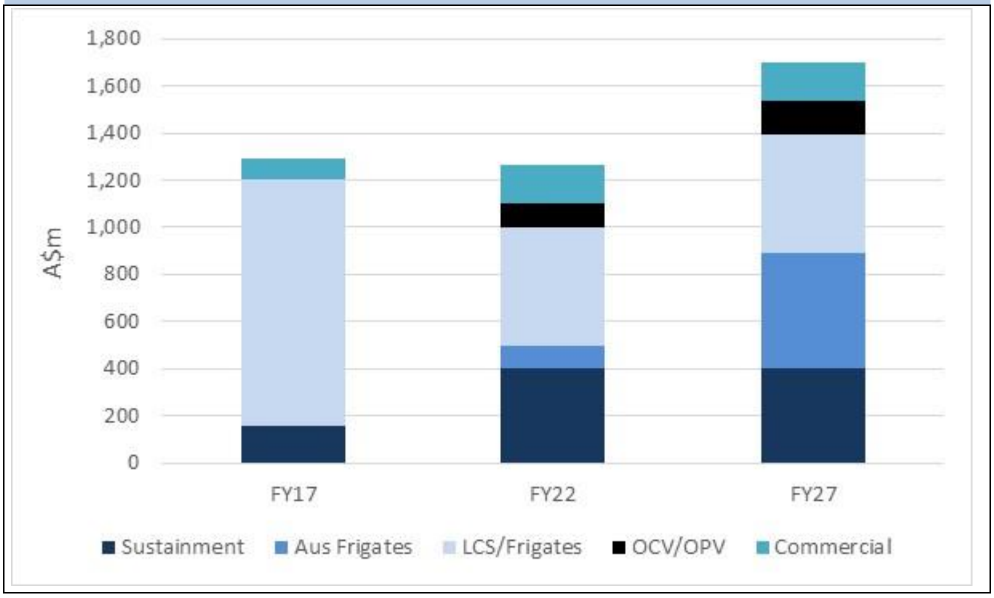
Fig. 7: ***EBIT Outlook – Existing Backlog***



Source: Hartleys Research

However, in the near term the outlook for revenue and earnings is underpinned by continued strength in the commercial market and existing US Navy orders. In the medium term ASB's proportion of workshare from the Australian Navy's OPV programme will be a key factor in determining FY20 revenue and beyond. Longer term, the two Frigate contracts (US Navy LCS/frigate extension and the RAN's Future Frigate programme) will be crucial, both are likely to be awarded in the next 18-24 months. At the moment, we assume 50% is awarded to ASB from the former and 25% from the latter.

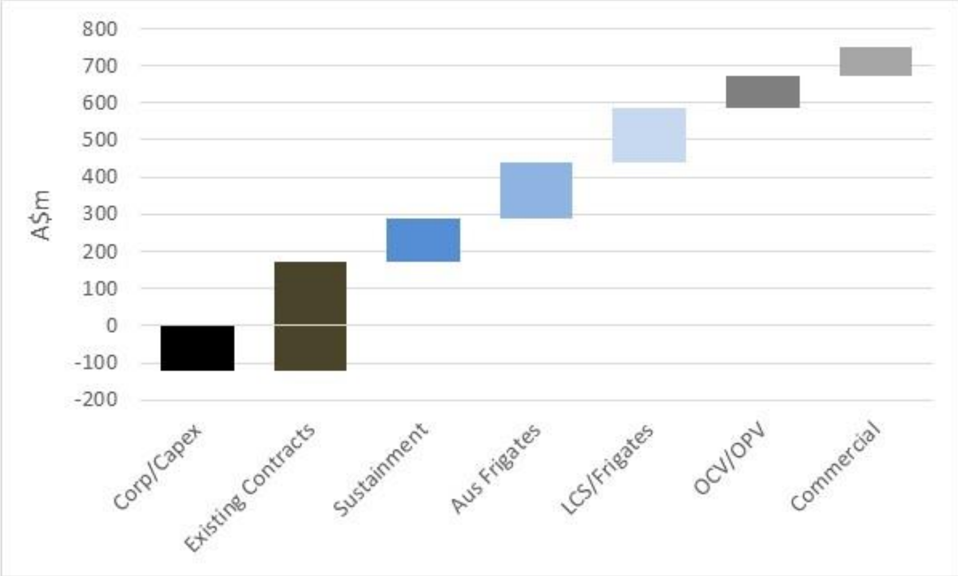
Fig. 8: ***Long Run Revenue***



Source: Hartleys Research

Continuing to assume 80% of the OPV contract and ongoing growth in both the commercial business (especially utilising spare capacity in the Philippines) and sustainment revenue, results in an NPV10 (Net Present Value discounted at 10%) of circa $2.09per share (on the basis of a long run AUD/USD exchange rate of US$76c per A$1).

Fig. 9: *NPV10 – Base Case*



Source: Hartleys Research

The downside for the stock price if it does not win a significant portion of the Future Frigate and LCS/Frigate contracts would obviously be material. However, not as significant as suggested by simply removing these from our NPV10 analysis. We would expect a significant portion of the freed-up capacity to be filled over time with commercial contracts (where the market is improving) and we would expect the US Navy to also keep the Mobile yard at a reasonable level of capacity through further sustainment work and perhaps an extension to the successful Expeditionary Fast Transport programme (beyond the current 12 vessels).

ASB is unique in that there are no other Naval contractors listed on the ASX. So, we have selected the S&P/ASX 300 Industrials (ex-BIP and Tech) as the most relevant benchmark for investors. The average multiple for this sector continues to increase (up between 20-30% over the past year) and this is behind the upgrade in our 12-month forward target price to $2.10 per share (from $1.86).

Fig. 10: *Valuation - Target Multiples*

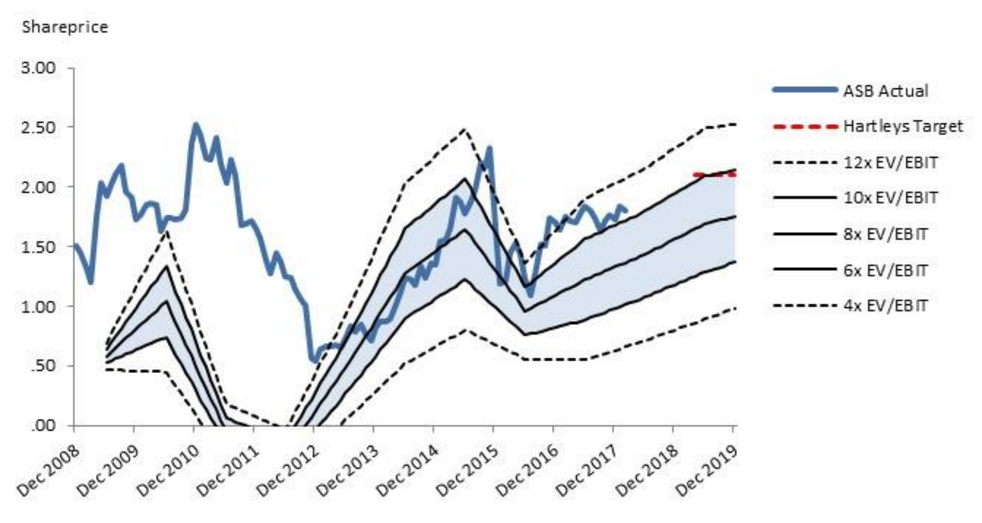
Valuation					
S&P/ASX Industrial:	**FY19 Multiple**	**ASX Comps**	**Target Multiple**	**Wgt.%**	**Tgt Price**
EV/EBIT	8.8x	12.3x	10.8x	10%	2.12
EV/EBITDA	5.9x	8.0x	7.0x	25%	2.07
Earnings	14.1x	18.7x	16.5x	30%	2.14
Div Yield	2.8%	3.1%	2.7%	0%	1.83
NPV				35%	2.09
Valuation					**$2.10**
upside from current					*18%*

Source: Hartleys Research

As discussed, if the Company does win larger portions of the Future Frigates and LCS/frigate programmes than we currently assume then a premium to the Industrials Index may be warranted.

On the basis of our current view on the likely outcome of the three major contracts bid on, we view fair value for ASB shares around $2.10 per share and as such rate ASB currently as a Neutral recommendation.

Fig. 11: EV/EBIT Band



Source: Hartleys Research

RISKS

A key risk for ASB, similar to other industrials, is the ability of management to replenish the order book. Capital intensive businesses, such as shipbuilding, require a relatively high level of plant capacity utilisation in order to generate an economic return. An inability to replenish the order book can lead to earnings disappointments. Such disappointments can be very difficult to predict and share price reactions can be severe and immediate upon disclosure by the company. Specific risks for ASB include cuts to the US and Australian naval budgets, failure to secure a portion of upcoming major contract awards and / or a sharp appreciation in the AUD / USD exchange rate.

SIMPLE S.W.O.T. TABLE

Strengths	Order book secures revenue through to FY18 and into FY19. Sustainment revenue: Contract with the US Navy should allow ASB to generate annuity service revenue from the LCS fleet once operational.
Weaknesses	Currently heavily reliant on a single customer (the US Navy). Capital intensive business that requires a relatively high level of yard utilisation to maintain margins.
Opportunities	Potential to win further orders from the US Navy, especially the LCS/frigate extension. Australian Governments' $89bn Naval replenishment programme, opportunity to secure a portion of the Future Frigates and / or OPV Programmes.
Threats	The majority of ASB's revenue is USD based. A strengthening of the AUD against the USD, therefore, could impact reported AUD earnings. Cuts to the US Navy's budget could have a long-term impact on ASB earnings.

Source: Hartleys Research

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Hartleys Recommendation Categories

Buy	Share price appreciation anticipated.
Accumulate	Share price appreciation anticipated but the risk/reward is not as attractive as a "Buy". Alternatively, for the share price to rise it may be contingent on the outcome of an uncertain or distant event. Analyst will often indicate a price level at which it may become a "Buy".
Neutral	Take no action. Upside & downside risk/reward is evenly balanced.
Reduce / Take profits	It is anticipated to be unlikely that there will be gains over the investment time horizon but there is a possibility of some price weakness over that period.
Sell	Significant price depreciation anticipated.
No Rating	No recommendation.
Speculative Buy	Share price could be volatile. While it is anticipated that, on a risk/reward basis, an investment is attractive, there is at least one identifiable risk that has a meaningful possibility of occurring, which, if it did occur, could lead to significant share price reduction. Consequently, the investment is considered high risk.

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