

AUSTAL LIMITED (ASB)

LCS review – write-downs but also clarity

The review of the LCS program has resulted in ASB having to write back work-in-progress because required modifications have increased the cost of the overall program. This will result in a significant EBIT (non-cash) loss in FY16 (guidance of A\$116-121m EBIT loss). A downgrade to FY17 guidance (EBIT of A\$45-55m) has resulted in a commensurate reduction in our earnings forecasts (-20% for FY17) and target price. Importantly ASB expects to be net cash (A\$49m) at the end of FY16 and pay a final dividend of 2cps. With only 30% upside to our revised 12-month target price of \$1.38, we have downgraded our recommendation from Buy to Accumulate.

LCS program review

The detailed review of the LCS program undertaken by ASB has revealed a material increase in the cost of the 11 vessels already complete and under construction (LCS6 to LCS26). The review was undertaken post the delivery of LCS6 and LCS8 and after the completion of the second of three shock trials on LCS6. The cost of modifications is exacerbated on the LCS program because of the concurrent (modular) construction process. If 10 vessels are under construction and a modification is required, the cost of a single modification is compounded. For LCS6, greater than 5,000 modifications were identified with 98% of these modifications now complete. For each subsequent vessel, the number of modifications required is reduced which should, therefore, improve margins.

The increase in the overall cost estimate has led to ASB having to write back US\$115m (A\$156m) of work-in-progress (WIP), which will be taken through the FY16 P&L. ASB books revenue on a percentage of completion basis based on an estimate of the overall cost of a vessel. If, therefore, the cost of the vessel is greater than the original estimate, the percentage complete will be overstated.

Guidance changes

ASB has provided the market with updated revenue and EBIT guidance. For FY16, revenue guidance has been reduced to A\$1.3bn compared to the previous consensus estimate of A\$1.5bn. FY16 EBIT loss is expected to be in the range of A\$116-121m. For FY17, revenue is expected to be A\$1.4bn with an EBIT between A\$45-55m. FY17 US shipbuilding EBIT margins are expected to be 5-7% compared to the previous guidance for FY16 of 4.5%-6.5%.

At the end of FY16, ASB was A\$49m net cash and generated A\$75m in cash flow before dividends and debt repayment (on an unaudited basis). The Company also expects to declare a final dividend of 2cps, bringing the full year dividend to 4cps.

Forecast changes and valuation

Our forecast changes are highlighted in Figure 3 on page 3. We have reduced our FY17 EBIT forecast by 19% to A\$52m and NPAT by 20% to A\$34m. We are using a USD/AUD FX rate of 0.71 for FY17. Given the uncertainty surrounding ASB's US operations over the last 6-months, we think it will require material evidence that the LCS program has stabilised before the market regains confidence in the story.

Share Price:	\$1.11
Valuation:	\$1.38
12mth price target:	\$1.38

Brief Business Description:

Commercial and naval marine design and construction.

Hartleys Brief Investment Conclusion

Austral (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	16.4%
John Rothwell	9.2%

Company Address:

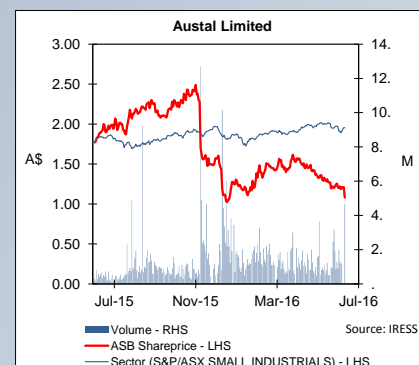
100 Clarence Beach Road
Henderson WA

Issued Capital:	348.0m		
- fully diluted	349.7m		
Market Cap:	\$386.2m		
- fully diluted	\$386.2m		
Net Debt (FY 16)	-\$33.1m		

	FY15a	FY16e	FY17e
Op Cash Flw	110.4	84.6	51.5
Free Cash Flw	88.6	66.6	26.1
NPAT* (A\$m)	45.0	122.5	34.3
EPS (\$, bas)	13.0	35.1	9.8
P/E (basic)	8.5x	-3.2x	11.3x
P/E (diluted)	8.6x	-3.2x	11.3x
EV / EBITDA	3.6x	5.7x	4.6x
DPS (cps)	4.0	4.0	4.0

Dividend Yield	3.6%	3.6%	3.6%
N.D. / equity	3%	-9%	-12%

Source: Hartleys Research. * normalised



Authors:

Simon Andrew
Energy & Industrials Analyst
Ph: +61 8 9268 3020
E: simon_andrew@hartleys.com.au

VALUATION AND EV/EBIT BANDS

Fig. 1: Valuation Methodology

	FY17 Multiple	Target Multiple	Wgt.%	Tgt Price
EV/EBIT	6.6x	9.0x	30%	1.30
Earnings	11.2x	12.0x	40%	1.18
Div Yield	3.6%	3.5%	10%	1.14
DCF			20%	2.02
12-month Target Price				\$1.38
upside from current				26%
P / E (6/16F) at price target				-3.9x
P / E (6/17F) at price target				14.1x
EV / EBITDA (6/17F) at price target				6.5x
EV / EBIT (6/17F) at price target				9.5x
Dividend Yield (6/17F) at price target				2.9%

Source: Hartleys Research

Fig. 2: Half yearly results summary – implied 2H performance

A\$ m	FY15			FY16			Current Period			
	1H	2H	FY	1H	2H F	FY F	HoH	YoY		
Revenue	A\$ m	619	822	1,441	747	552	1,299	-9.1%	20.7%	
EBITDA	A\$ m	45	52	97	42	20	62	-20.2%	-7.1%	
Margin %		7.3%	6.4%	6.8%	5.6%	3.6%	4.8%	-78 bps	-168 bps	
EBIT	A\$ m	34	40	73	29	(147)	(118)	-26.6%	-13.9%	
Margin %		5.44%	4.8%	5.08%	3.88%	-26.72%	-9.12%	-93 bps	-156 bps	
Interest Expense	A\$ m	(3)	(2)	(5)	(3)	(1)	(4)	15.5%	-6.4%	
PBT	A\$ m	35	34	69	27	(149)	(123)	-21.6%	-23.5%	
Tax	A\$ m	(14)	(14)	(28)	(10)	10	-	-26.7%	-28.8%	
Tax rate %		-39.9%	39.8%	39.9%	37.2%	6.7%	0.0%	-259 bps	7712 bps	
NPAT	A\$ m	21	24	45	17	(139)	(123)	-30.0%	-20.0%	
US	Revenue	A\$ m	498	622	1,120	638	448	1,086	2.7%	28.2%
		US\$	444	486	937	461	327	787		
	EBIT		27.4	31	58	27	6	33	-13.3%	-1.8%
	Margin %		5.5%	5.0%	5.2%	4.2%	1.4%	3.1%	-78 bps	-129 bps
Australia	Revenue	A\$ m	110	102	212	106	65	170	3.7%	-4.0%
	EBIT	A\$ m	14.5	17	32	11	10	21	-34.7%	-22.1%
	Margin %		13.2%	17.0%	15.0%	10.7%	12.0%	12.5%	-629 bps	-248 bps
Philippines	Revenue	A\$ m	20	18	39	16	24	41	-11.6%	-19.7%
	EBIT	A\$ m	1.9	(1)	1	1	1	2	-166.1%	-68.4%
	Margin %		9.4%	-4.9%	2.6%	3.7%	7.5%	5.0%	860 bps	-568 bps

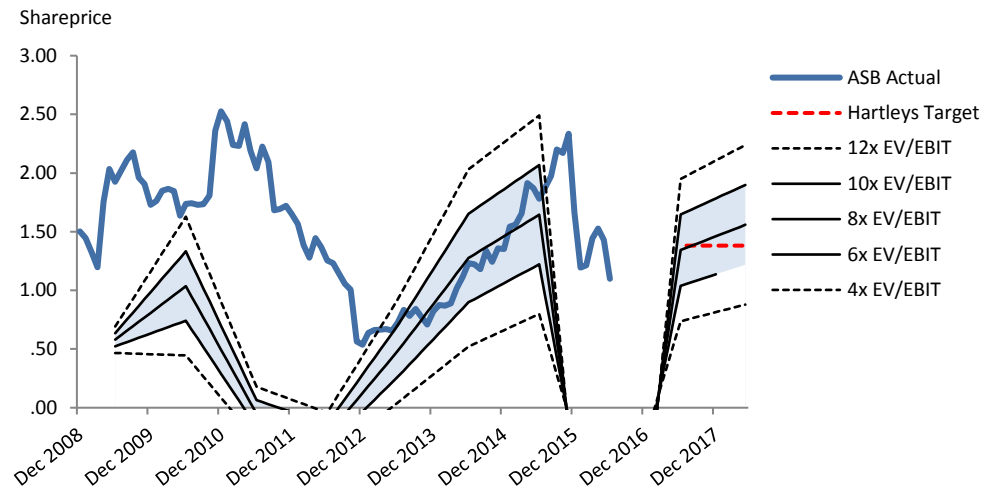
Source: Hartleys Research

Fig. 3: Forecast Changes

A\$ m	FY15		FY16		FY17			FY18		
	Act	Old	New	% diff	Old	New	% diff	Old	New	% diff
Revenue	1,415	1,438	1,299	-10%	1,547	1,420	-8%	1,708	1,397	-18%
USA	1,120	1,225	1,086	-11%	1,366	1,247	-9%	1,526	1,216	-20%
Australia	212	170	170	0%	138	131	-5%	135	135	0%
Philippines	31	41	41	0%	41	41	0%	42	42	0%
Other	45	2	2	0%	2	2	0%	5	5	0%
EBITDA -Divisional	97	83	62	-25%	89	77	-14%	104	87	-16%
USA	77	73	52	-29%	83	73	-12%	99	83	-16%
Australia	33	22	22	0%	18	16	-11%	18	18	-3%
Philippines	2	3	3	0%	5	4	-12%	5	5	-12%
Other	-15	-16	-16	0%	-17	-17	0%	-18	-18	0%
EBIT - Divisional	73.2	58	-118	-303%	65	52	-19%	76	59	-22%
USA	58	54	33	-39%	64	54	-16%	78	62	-20%
Australia	32	21	21	0%	17	15	-11%	17	16	-3%
Philippines	1	2	2	0%	4	3	-17%	4	3	-17%
Other	-18	-19	-175	818%	-20	-20	0%	-22	-22	0%
NPAT	45.0	36.9	-122.5	-432%	43.1	34.3	-20%	51.5	39.5	-23%

Source: Hartleys Research

Fig. 4: EV/EBIT Bands



Source: Hartleys Research

Fig. 5: Global Defense Contractors – Bloomberg Estimates

Bloomberg Consensus Estimates												
NAME	TICKER	Last Price	M. CAP (A\$m)	Net Debt	EV (A\$m)	EBIT / Sales FY2	NPAT growth			EV/EBITDA		
							FY0	FY1	FY2	FY0	FY1	FY2
Defence Contractors												
Global												
AUSTAL LTD	ASB AU	1.26	435	33	468	4.4%	-15.8%	14.9%	11.7%	4.9	5.4	5.0
GENERAL DYNAMICS CORP	GD US	140.92	44,106	274	44,380	13.3%	-0.9%	2.1%	3.8%	9.4	9.4	9.2
RAYTHEON COMPANY	RTN US	134.80	40,305	2,394	42,700	13.7%	4.0%	9.0%	9.5%	12.2	11.7	10.7
NORTHROP GRUMMAN CORP	NOC US	215.16	39,009	4,279	43,288	12.9%	2.9%	8.6%	10.4%	12.2	12.7	11.5
LOCKHEED MARTIN CORP	LMT US	238.64	72,308	10,927	83,235	12.3%	1.4%	13.0%	9.4%	12.6	11.8	10.8
BAE SYSTEMS PLC	BA/ LN	4.95	15,661	1,563	17,224	10.0%	3.8%	6.2%	4.7%	8.8	8.1	7.7
HUNTINGTON INGALLS INDUSTRIAL	HII US	160.63	7,534	19	7,552	10.7%	5.1%	-2.4%	0.6%	7.6	8.0	7.7
BOEING CO/THE	BA US	132.75	88,494	-1,305	87,190	9.2%	9.0%	6.2%	7.6%	9.6	8.5	8.1
median			39,657			11.5%	3.4%	7.4%	8.5%	9.5	8.9	8.6
average			38,482			10.8%	1.2%	7.2%	7.2%	9.7	9.4	8.8

Bloomberg Consensus Estimates											P/E (dil. for new shs)		
NAME	TICKER	Last Price	M. CAP (A\$m)	Net Debt	EV (A\$m)	EBIT / Sales FY2	EV/EBIT			(curr mkt cap / NPAT)			
							FY0	FY1	FY2	FY0	FY1	FY2	
Defence Contractors													
Global													
AUSTAL LTD	ASB AU	1.26	435	33	468	4.4%	6.5	7.6	6.9	9.6	11.5	10.0	
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NORTHROP GRUMMAN CORP	NOC US	215.16	39,009	4,279	43,288	12.9%	14.2	14.8	13.6	20.8	20.2	18.6	
LOCKHEED MARTIN CORP	LMT US	238.64	72,308	10,927	83,235	12.3%	15.0	14.7	13.4	20.3	20.0	17.7	
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HUNTINGTON INGALLS	HII US	160.63	7,534	19	7,552	10.7%	9.5	10.0	10.0	16.7	15.9	16.3	
BOEING CO/THE	BA US	132.75	88,494	-1,305	87,190	9.2%	11.8	10.4	9.9	17.3	15.9	15.0	
median			39,657			11.5%	11.4	10.5	10.1	17.0	15.9	15.6	
average			38,482			10.8%	11.6	11.4	10.7	16.6	16.3	15.2	

Source: Bloomberg

HARTLEYS CORPORATE DIRECTORY

Research

Trent Barnett	Head of Research	+61 8 9268 3052
Mike Millikan	Resources Analyst	+61 8 9268 2805
Scott Williamson	Resources Analyst	+61 8 9268 3045
Simon Andrew	Energy Analyst	+61 8 9268 3020
Janine Bell	Research Assistant	+61 8 9268 2831

Corporate Finance

Dale Bryan	Director & Head of Corp Fin.	+61 8 9268 2829
Richard Simpson	Director	+61 8 9268 2824
Paul Fryer	Director	+61 8 9268 2819
Ben Wale	Associate Director	+61 8 9268 3055
Ben Crossing	Associate Director	+61 8 9268 3047
Stephen Kite	Associate Director	+61 8 9268 3050
Scott Weir	Associate Director	+61 8 9268 2821
Rhys Simpson	Manager	+61 8 9268 2851

Registered Office

Level 6, 141 St Georges Tce Postal Address:

PerthWA 6000	GPO Box 2777
Australia	Perth WA 6001
PH:+61 8 9268 2888	FX: +61 8 9268 2800
www.hartleys.com.au	info@hartleys.com.au

Note: personal email addresses of company employees are structured in the following manner:firstname_lastname@hartleys.com.au

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.

Institutional Sales

Carrick Ryan	+61 8 9268 2864
Justin Stewart	+61 8 9268 3062
Simon van den Berg	+61 8 9268 2867
Chris Chong	+61 8 9268 2817
Digby Gilmour	+61 8 9268 2814
Veronika Tkacova	+61 8 9268 3053

Wealth Management

Nicola Bond	+61 8 9268 2840
Bradley Booth	+61 8 9268 2873
Adrian Brant	+61 8 9268 3065
Nathan Bray	+61 8 9268 2874
Sven Burrell	+61 8 9268 2847
Simon Casey	+61 8 9268 2875
Tony Chien	+61 8 9268 2850
Tim Cottee	+61 8 9268 3064
David Cross	+61 8 9268 2860
Nicholas Draper	+61 8 9268 2883
John Featherby	+61 8 9268 2811
Ben Fleay	+61 8 9268 2844
James Gatti	+61 8 9268 3025
John Goodlad	+61 8 9268 2890
Andrew Gribble	+61 8 9268 2842
David Hainsworth	+61 8 9268 3040
Neil Inglis	+61 8 9268 2894
Murray Jacob	+61 8 9268 2892
Gavin Lehmann	+61 8 9268 2895
Shane Lehmann	+61 8 9268 2897
Steven Loxley	+61 8 9268 2857
Andrew Macnaughtan	+61 8 9268 2898
Scott Metcalf	+61 8 9268 2807
David Michael	+61 8 9268 2835
Jamie Moullin	+61 8 9268 2856
Chris Munro	+61 8 9268 2858
Michael Munro	+61 8 9268 2820
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Charlie Ransom	+61 8 9268 2868
Conlie Salvemini	+61 8 9268 2833
Mark Sandford	+61 8 9268 3066
David Smyth	+61 8 9268 2839
Greg Soudure	+61 8 9268 2834
Sonya Soudure	+61 8 9268 2865
Dirk Vanderstruyf	+61 8 9268 2855
Samuel Williams	+61 8 9268 3041
Jayme Walsh	+61 8 9268 2828

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