

Austal Limited

Significant Opportunity Pipeline Ahead

ASB reported 1H17 underlying EBIT of A\$31.2m, up +19.6% on the pcp, and ahead of our A\$23.3m forecast. While the company reported surprise one-off settlement provisions relating to a vessel constructed seven years ago, underlying earnings were stronger than expected, with the company upgrading underlying EBIT guidance to A\$55-60m (previously A\$45-55m). The company has highlighted a significant tender pipeline, both in Australia and the US, the largest in the company's history. While tender success (or contract profitability) is not a certainty, we believe the company is very well positioned to win a significant portion of this future work. Following recent political developments and the company's recent block buy bid, we believe there is now more clarity on the future of the LCS program and have adjusted our US earnings forecasts in future years.

- **Surprise one-off provision, but underlying earnings upgrade.** ASB reported 1H17 underlying EBIT of A\$31.2m, up +19.6% on the pcp, and ahead of our A\$23.3m forecast. Statutory EBIT of A\$18.1m was down significantly on the pcp, impacted by a one-off settlement provision relating to a settlement of a latent defect claim that was under arbitration (A\$13.2m). A fully franked interim dividend of 2.0cps was declared, in-line with our 2.0cps forecast.
- **Significant pipeline of work on the horizon.** The company currently sees a significant pipeline of potential work on the horizon across numerous areas: 1) a 13 ship block buy has just been submitted for the US LCS program valued at ~US\$6.5bn, 2) the company will submit a bid in Mar-16 for the Australian Offshore Patrol Vessel program valued at ~A\$3bn (~A\$1bn to construct, ~A\$2bn support); success in this program could support a tender for the Australian Future Frigate program that is expected to start in 2020 (valued at ~A\$10bn), 3) the large commercial passenger ferry market appears to have restarted with the company fielding a number of inbound queries and 4) following success with the US Navy, export opportunities are emerging for variants of ASB's EPF vessel.

Overweight

ASB.AX, ASB AU

Price: A\$1.72

▲ **Price Target: A\$1.95**
 Previous: A\$1.75

Australia

Emerging Companies

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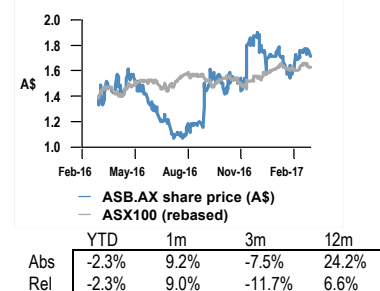
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J.P. Morgan Securities Australia Limited

Price Performance



Austal Limited (Reuters: ASB.AX, Bloomberg: ASB AU)

Year-end Jun (A\$)	FY15A	FY16A	FY17E	FY18E	FY19E
Revenue (A\$ mn)	1,434	1,511	1,355	1,412	1,031
EBITDA (A\$ mn)	97	79	92	95	74
Net Profit (A\$ mn)	53	(84)	27	38	27
EPS (A\$)	0.16	(0.24)	0.08	0.11	0.08
P/E (x)	11.1	NM	22.8	16.0	22.7
EV/EBITDA (x)	6.4	7.0	6.5	5.9	6.9
DPS (A\$)	0.04	0.04	0.04	0.04	0.04
Dividend Yield	2.3%	2.3%	2.3%	2.3%	2.3%
Normalised EPS (A\$)	0.13	0.10	0.10	0.11	0.08
Normalised EPS Growth	16.8%	(23.8%)	1.8%	5.9%	(29.4%)
Normalised PE	13.1	17.3	16.9	16.0	22.7

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Shares O/S (mn)	349
Market Cap (A\$ mn)	600.88
Market Cap (\$ mn)	461.04
Price (A\$)	1.72
Date Of Price	27 Feb 17
Free Float(%)	-
3M - Avg daily vol (mn)	0.67
3M - Avg daily val (A\$ mn)	1.16
3M - Avg daily val (\$ mn)	0.9
ASX100	4752.00
Exchange Rate	0.77
Price Target End Date	31-Dec-17
Price Target (A\$)	1.95

See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.

J.P. Morgan does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

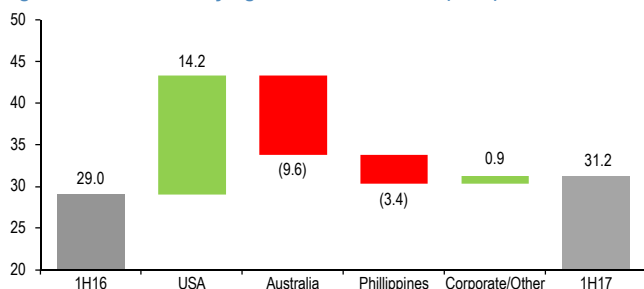
1H17 Results: Charting the Focal Points

Result impacted by settlement

ASB reported 1H17 underlying EBIT of A\$31.2m, up +19.6% on the pcp, and ahead of our A\$23.3m forecast. Statutory EBIT of A\$18.1m was down significantly on the pcp, impacted by a one-off settlement provision relating to a settlement of a latent defect claim that was under arbitration (A\$13.2m).

The company increased guidance for FY17 EBIT of A\$55-60m (previously A\$45-55m), while effectively retaining statutory EBIT guidance for A\$45-50m (prev. A\$45-55m).

Figure 1: ASB – Underlying EBIT 1H17 vs 1H16 (A\$m)



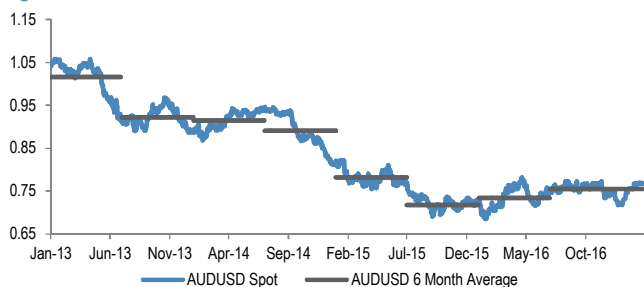
Source: Company reports, J.P. Morgan estimates.

USD tailwind now a slight headwind

ASB is a key beneficiary from a stronger USD given: 1) Reduces input costs into the US and makes the Australian operations more competitive, and 2) AUD earnings benefit from the translation of earnings from the US business.

While the strengthening USD has been a meaningful tailwind in prior periods, this benefit has started to dissipate in 2H16 before becoming a slight headwind in 1H17.

Figure 3: AUDUSD FX Rate

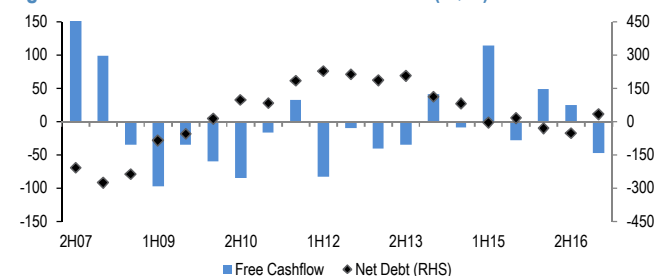


Source: Bloomberg.

Balance sheet swings to net debt

ASB reported operating cash flow of -A\$43.8m, down significantly on the +A\$60.9m reported in the pcp. The 1H17 result was negatively impacted by the timing of cash payments from the US Government (which equate to ~A\$50m on a fortnightly basis). Investing cash flows outflows were also higher in the period the construction of 2 Cape Class Patrol Boats which will be chartered by NAB to the Royal Australian Navy for a minimum term of three years. Net debt as at Dec-16 was A\$32.6m.

Figure 2: ASB – Free Cash flow and Net Debt (A\$m)

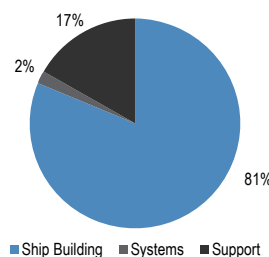


Source: Company reports.

Construction still the main earnings driver

The shipbuilding operations, particularly in the US, for a number of years have been the key earnings driver of the group. In 1H17, shipbuilding still contributed ~81% of group EBIT (ex Other) on an underlying basis, with the vast majority coming from the US. In 1H17, ASB's Support business only contributed ~17% of group EBIT, with the company focused on increasing this business and moving towards the level (25-30%) seen at other major shipbuilding contractors.

Figure 4: ASB – 1H17 Segment EBIT Contribution



Source: Company reports, J.P. Morgan estimates.

ASB reported 1H17 underlying EBIT of A\$31.2m, up +19.6% on the pcp, and ahead of our A\$23.3m forecast. Statutory EBIT of A\$18.1m was down significantly on the pcp, impacted by a one-off settlement provision relating to a settlement of a latent defect claim that was under arbitration (A\$13.2m). The company increased guidance for FY17 EBIT of A\$55-60m (previously A\$45-55m), while effectively retaining statutory EBIT guidance for A\$45-50m (previously A\$45-55m).

A fully franked interim dividend of 2.0cps was declared, in-line with our 2.0cps forecast.

Table 1: ASB - Financial Summary

A\$ in millions

	1H15	2H15	1H16	2H16	1H17	% Change	
						1H on 1H	1H on 2H
Revenue	688.0	746.2	757.7	753.4	657.6	-13.2%	-12.7%
Operating Costs	(643.1)	(693.7)	(716.0)	(716.2)	(611.1)	-14.6%	-14.7%
EBITDA	44.9	52.6	41.8	37.2	46.5	11.2%	25.1%
% EBITDA Margin	6.5%	7.0%	5.5%	4.9%	7.1%	1.55ppt	2.14ppt
Depreciation & Amortisation	(11.1)	(13.1)	(12.7)	(17.2)	(15.2)	19.6%	-11.1%
EBIT	33.7	39.4	29.0	20.0	31.2	7.5%	56.1%
% EBIT Margin	4.9%	5.3%	3.8%	2.7%	4.7%	0.92ppt	2.09ppt
Net Interest Expense	(2.1)	(2.0)	(2.3)	(3.2)	(3.0)	32.9%	-5.7%
Profit Before Tax	31.6	37.5	26.8	16.8	28.2	5.4%	67.9%
Tax Expense	(10.6)	(13.5)	(9.9)	1.2	(9.6)	-3.0%	-935.7%
Outside Equity Interest	(0.0)	0.1	(0.1)	0.0	0.0	-100.0%	#DIV/0!
Profit After Tax Before Sig Items	21.0	24.1	16.7	18.0	18.6	11.0%	3.4%
Pre Tax Significant Items	11.3	0.3	0.0	(169.9)	(13.2)	na	-92.3%
Tax Expense	(3.4)	(0.1)	0.0	51.0	3.9	na	-92.3%
Reported NPAT	28.9	24.3	16.7	(101.0)	9.3	-44.1%	-109.3%
Reported EPS	8.4¢	7.0¢	4.7¢	(29.0¢)	2.6¢	-44.2%	-109.1%
DPS	1.0¢	3.0¢	2.0¢	2.0¢	2.0¢	0.0%	0.0%

Source: Company reports.

Divisional Summary

United States

Table 2: ASB - United States Financial Summary#

A\$ in millions

	1H15	2H15	1H16	2H16	1H17	% Change	
						1H on 1H	1H on 2H
Revenue*	498.3	621.4	638.4	650.5	594.3	-6.9%	-8.6%
EBIT	27.4	31.1	26.9	38.6	41.1	53.0%	6.4%
% EBIT Margin	5.5%	5.0%	4.2%	5.9%	6.9%	2.71ppt	0.98ppt

Source: Company reports. * External revenues. # Adjusted for one-off items.

The US division reported revenue of A\$594.3m, down -6.9% on the pcp with segment EBIT of A\$41.1m up +53.0% on the pcp. The result was driven by work on 13 ship construction projects across ASB's two major vessel contracts for the U.S. Navy; the ~US\$4bn LCS contract and ~US\$1.9bn EPF contract.

The US shipbuilding EBIT margin was 6.6%, in line with the company's guidance range of 5-7%. However, the company has indicated that further evidence of progress over at least the next 6 months will be necessary to provide real confidence that the turnaround is complete.

Revenue in the support business was up +78% on the pcp A\$55.8 million and EBIT margins at 12.5% (this was above normal expectations as a result of the benefit of profit awarded by the US Navy in 1H17 that related to FY16 activity).

Australia

Table 3: ASB - Australia Financial Summary#

A\$ in millions

	1H15	2H15	1H16	2H16	1H17	% Change	
						1H on 1H	1H on 2H
Revenue*	98.0	93.3	95.8	77.8	40.1	-58.2%	-48.5%
EBIT	14.5	17.3	11.3	(3.4)	1.7	-84.6%	-150.6%
% EBIT Margin	14.8%	18.5%	11.8%	-4.4%	4.4%	-7.45ppt	8.78ppt

Source: Company reports. * External revenues. # Adjusted for one-off items.

The Australian division reported external revenue of A\$40.1m down -58.2% on the pcp and EBIT of A\$1.7m, down -84.6% on the pcp. As indicated previously, ASB expects FY17 to be a year of lower profitability in Australia given that the shipyard is completing previous programs and is now in the front-end design phase on two significant vessel programs; the A\$305m Pacific Patrol Boat program and ~\$90m 109m Mols vehicle passenger ferry.

Current year profitability will also be affected by the two Cape Class vessels being completed for the Royal Australian Navy under a bank leasing arrangement. These ships will only generate accounting profit during the lease period rather than during construction as would normally be the case. As such, it is likely that profit will not be recognised on the first PPB vessel until delivery scheduled for October 2018.

Philippines

Table 4: ASB - Philippines Financial Summary#

A\$ in millions

	1H15	2H15	1H16	2H16	1H17	% Change	
						1H on 1H	1H on 2H
Revenue*	14.9	15.7	11.8	15.3	12.7	7.7%	-17.1%
EBIT	1.9	(0.9)	0.6	(4.3)	(2.8)	-591.1%	-35.0%
% EBIT Margin	12.7%	-5.7%	4.9%	-28.3%	-22.2%	-27.01ppt	6.12ppt

Source: Company reports. * External revenues. # Adjusted for one-off items.

The Philippines division reported revenue of A\$12.7m up +7.7% on the pcp and EBIT of -A\$2.8m, down significantly on the pcp. Three smaller commercial vessels were under construction at the shipyard in the half but the low revenue levels do not meet the breakeven run rate for the yard.

The commercial vessel pipeline includes several larger ferries which will maintain revenue in the Philippines beyond the economic breakeven point if contracted. Importantly following management and organisational improvements implemented at the beginning of the year, construction of the vessels is currently performing well and within schedule.

Earnings Forecasts Revisions

Following the 1H17 result, we have adjusted our earnings forecasts as detailed in the table below:

Table 5: ASB - Earnings Forecasts Revisions

Year to 30 June 2017	Revised	Previous	% Change
EBITDA (A\$m)	91.8	78.8	16.6%
NPAT (A\$m)	26.6	28.8	(7.5%)
Norm NPAT (A\$m)	35.8	28.8	24.5%
EPS (c)	7.5	8.2	(8.4%)
Norm EPS (c)	10.2	8.2	23.3%
DPS (c)	4.0	4.0	0.0%
Year to 30 June 2018	Revised	Previous	% Change
EBITDA (A\$m)	94.6	86.1	9.8%
NPAT (A\$m)	38.0	33.4	13.9%
Norm NPAT (A\$m)	38.0	33.4	13.9%
EPS (c)	10.7	9.5	13.2%
Norm EPS (c)	10.7	9.5	13.2%
DPS (c)	4.0	4.0	0.0%
Year to 30 June 2019	Revised	Previous	% Change
EBITDA (A\$m)	74.0	74.2	(0.2%)
NPAT (A\$m)	26.9	28.2	(4.6%)
Norm NPAT (A\$m)	26.9	28.2	(4.6%)
EPS (c)	7.6	8.0	(5.1%)
Norm EPS (c)	7.6	8.0	(5.1%)
DPS (c)	4.0	4.0	0.0%

Source: Company reports, J.P. Morgan estimates.

Our share price target has been adjusted to reflect our new valuation on the company, which has been impacted by the earnings changes detailed above.

Investment Thesis, Valuation and Risks

Austal Limited (*Overweight; Price Target: A\$1.95*)

Investment Thesis

Austal (ASB) designs and manufactures customised aluminium defence and commercial vessels; its customers include many of the world's leading ferry operators and defence forces.

Valuation

Our Dec17 share price target of A\$1.95 is based on our DCF valuation of A\$1.74 per share (WACC: 10.3%, Forecast period: 10 years, Terminal value: assumes the company does not generate ROIC above WACC in perpetuity). Our price target is based on the future value of our valuation, less any dividends to be paid between now and the target date.

Risks to Rating and Price Target

The key risks to our rating and share price target include: 1) Currency movements impacting the translation of foreign earnings and the competitiveness of the company's shipbuilding operations. 2) US budget and allocation of funding to the Department of Defense. 3) General economic environment, impacting the demand for vessels. 4) Operational risk, impacting the margins generated from large capital projects.

Austal Limited

Relative recommendation:

Overweight

A\$ in millions, year end Jun

Profit And Loss	FY15	FY16	FY17E	FY18E	FY19E	Valuation Summary	A\$m	A\$ps			
Revenue	1,434	1,511	1,355	1,412	1,031	Current mkt capitalisation	600.88	1.72			
Revenue growth	25.7%	5.4%	(10.3%)	4.2%	(27.0%)	Price Target		1.95			
COGS	(1,297)	(1,386)	0	0	0	Capital growth to price target		13.6%			
Operating Expenses	(40)	(46)	(1,263)	(1,317)	(957)						
EBITDA	97	79	92	95	74						
EBITDA growth	9.3%	(19.0%)	16.3%	3.0%	(21.7%)	Trading Multiples	FY15	FY16	FY17E	FY18E	FY19E
EBITDA margin	6.8%	5.2%	6.8%	6.7%	7.2%	PE Pre-abnormals	13.1	17.3	16.9	16.0	22.7
Amortisation	(2)	(1)	(1)	(1)	(1)	PE Reported	11.1	NM	22.8	16.0	22.7
Depreciation	(23)	(28)	(30)	(31)	(30)	EV/EBITDA	6.4	7.0	6.5	5.9	6.9
EBIT	73	49	60	63	43	EV/EBIT	8.5	11.3	9.8	8.9	11.9
Other Income	-	-	-	-	-	Key Ratios	FY15	FY16	FY17E	FY18E	FY19E
Other Expenses	-	-	-	-	-	Dividend Yield	2.3%	2.3%	2.3%	2.3%	2.3%
Net Interest	(4)	(5)	(6)	(5)	(2)	Franking	100.0%	100.0%	100.0%	100.0%	100.0%
Pre-Tax Profit	69	44	54	58	41	Return on Assets (%)	4.5%	3.3%	3.6%	3.8%	2.8%
Tax	(24)	(9)	(19)	(20)	(14)	Return on Equity (%)	9.5%	7.1%	7.6%	7.6%	5.2%
Tax Rate	34.8%	20.2%	34.1%	34.0%	34.0%	ROIC (%)	7.6%	6.0%	6.3%	6.6%	4.7%
Minorities	0	(0)	0	0	0	Leverage	FY15	FY16	FY17E	FY18E	FY19E
Abnormals (post tax)	8	(119)	(9)	0	0	Gearing (Net Debt / Equity)	3.2%	(11.3%)	(2.6%)	(8.8%)	(18.1%)
Reported NPAT	53	(84)	27	38	27	Gearing (ND / (ND + E))	3.1%	(12.7%)	(2.6%)	(9.7%)	(22.1%)
Normalised NPAT	45	35	36	38	27	Net Debt / EBITDA	16.6%	(65.5%)	(13.6%)	(47.9%)	(128.2%)
Growth	17.4%	(23.1%)	3.4%	6.2%	(29.4%)	EBIT Interest Cover (x)	17.8	8.9	10.0	12.3	20.0
End of Period Shares	347	348	350	350	350	Balance Sheet	FY15	FY16	FY17E	FY18E	FY19E
EFPOWA	345	348	353	354	354	Cash	138	224	153	153	153
Reported EPS (\$)	0.16	(0.24)	0.08	0.11	0.08	Receivables	104	128	113	118	81
Normalised EPS (\$)	0.13	0.10	0.10	0.11	0.08	Investments	-	-	-	-	-
Growth	16.8%	(23.8%)	1.8%	5.9%	(29.4%)	Inventories	340	109	151	157	108
DPS (\$)	0.04	0.04	0.04	0.04	0.04	Other Current Assets	16	8	24	24	24
Growth	-	0.0%	0.0%	0.0%	0.0%	Total Current Assets	599	470	441	452	367
DPS/EPS payout	25.9%	NM	53.0%	37.2%	52.7%	Net PPE	443	491	518	511	498
Cash Flow Statement	FY15	FY16	FY17E	FY18E	FY19E	Total Intangibles	10	9	9	8	8
Net Profit for Cashflow	73	(121)	60	63	43	Other Non Current Assets	20	43	31	31	31
Depreciation & Amortisation	24	30	31	32	31	Total Non Current Assets	472	543	557	550	537
Non Cash Items	-	-	-	-	-	Total Assets	1,071	1,013	999	1,002	904
Working Capital Changes	20	213	(68)	(3)	24	Creditors	223	230	189	196	135
Other Operating Cashflows	(2)	(6)	(5)	(22)	(17)	Current Borrowings	147	3	3	3	3
Cashflow from Operating Activities	115	117	19	70	81	Current Tax Provisions	7	0	7	8	5
Capex	(27)	(39)	(15)	(24)	(18)	Other Current Provisions	34	42	59	61	63
Net Acquisitions	0	0	(30)	0	0	Other Current Liabilities	51	32	39	40	40
Other Investing cashflows	0	0	0	0	0	Total Current Liabilities	462	307	296	307	246
Investing Cash Flow	(27)	(39)	(45)	(24)	(18)	Non Current Creditors	-	-	-	-	-
Inc/(Dec) in Borrowings	(31)	11	(38)	(33)	(50)	Non Current Borrowings	8	170	138	106	56
Equity Issued	0	0	0	0	0	Deferred Tax Liabilities	9	0	0	0	0
Dividends Paid	(3)	(16)	(12)	(13)	(14)	Other Non Current Provisions	1	1	1	1	1
Other Financing Cashflows	0	0	0	0	0	Other Non Current Liabilities	78	78	76	76	76
Financing Cash Flow	(35)	(5)	(50)	(46)	(64)	Total Non Current Liabilities	96	249	215	182	133
Net Cash Flow	65	69	(71)	0	0	Total Liabilities	558	556	512	490	379
						Equity	113	115	117	118	118
						Other Equity	0	0	0	0	0
						Reserves	56	101	111	111	111
						Retained Profits	344	242	259	283	296
						Outside Equity Interests	0	0	0	0	0
						Total Shareholders Equity	512	458	487	512	525
						Net Debt	16	(52)	(13)	(45)	(95)

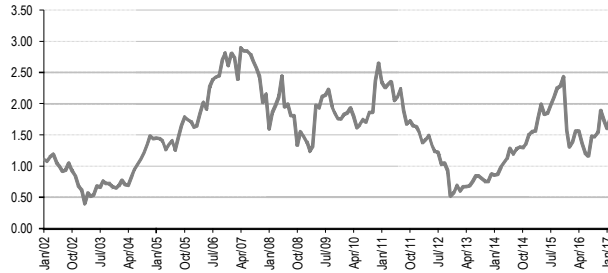
Source: Company reports and J.P. Morgan estimates.

JPM Q-Profile
Austal Limited (AUSTRALIA / Industrials)
 As Of: 24-Feb-2017

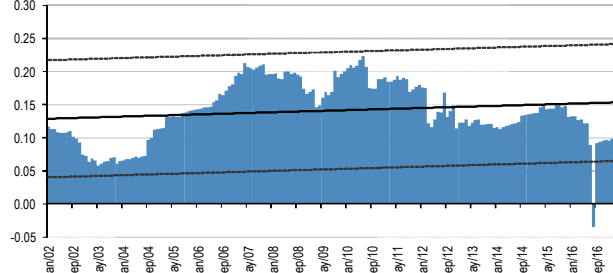
Global Equity Quantitative Analysis

Quant_Strategy@jpmorgan.com

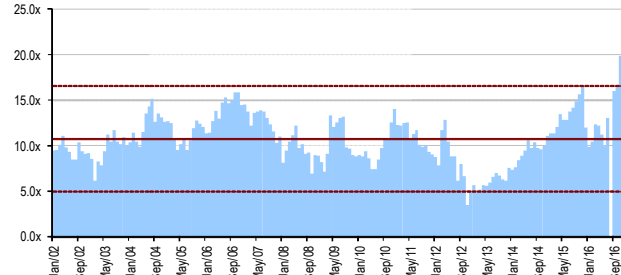
Local Share Price **Current:** 1.78



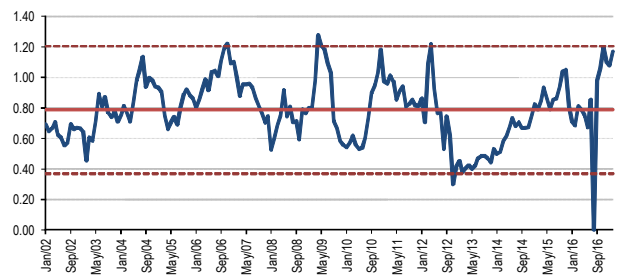
12 Mth Forward EPS **Current:** 0.10



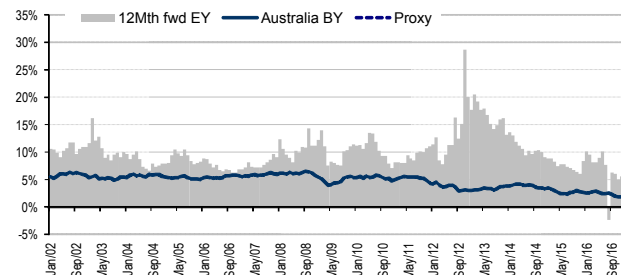
PE (1Yr Forward) **Current:** 18.1x



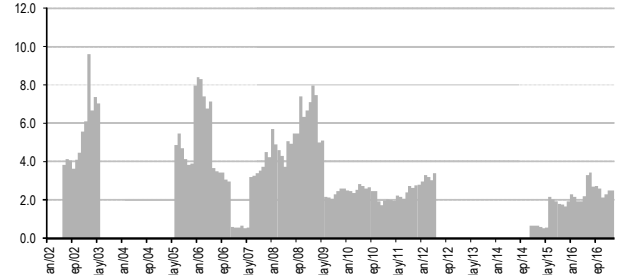
P/E Relative to S&P/ASX 200 Index **Current:** 1.17



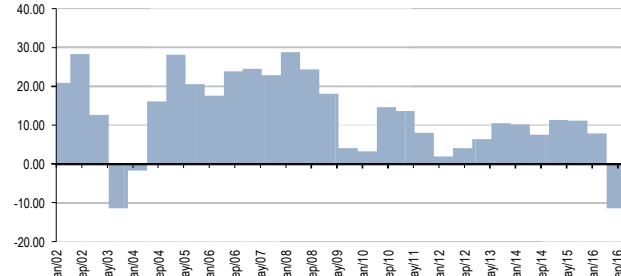
Earnings Yield (& Local Bond Yield) **Current:** 5.54%



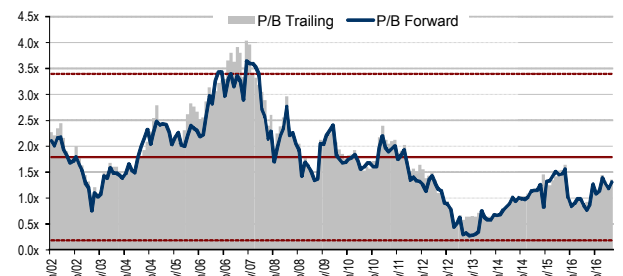
Dividend Yield (Trailing) **Current:** 2.50



ROE (Trailing) **Current:** -17.38



Price/Book (Value) **Current:** 1.4x



Summary

Austal Limited		TICKER ASB AU EQUITY							As Of: 24-Feb-17			
AUSTRALIA									Local Price: 1.78			
Industrials									EPS: 0.10			
	Latest	Min	Max	Median	Average	2 S.D.+	2 S.D. -	% to Min	% to Max	% to Med	% to Avg	
12mth Forward PE	18.05x	0.00	19.83	10.43	10.73	16.53	4.93	-100%	10%	-42%	-41%	
P/BV (Trailing)	1.35x	0.47	4.04	1.66	1.79	3.40	0.19	-66%	199%	22%	33%	
Dividend Yield (Trailing)	2.50	0.00	9.62	2.16	2.34	6.98	-2.30	-100%	285%	-14%	-6%	
ROE (Trailing)	-17.38	-17.38	28.82	11.32	12.08	34.02	-9.86	0%	266%	165%	169%	

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

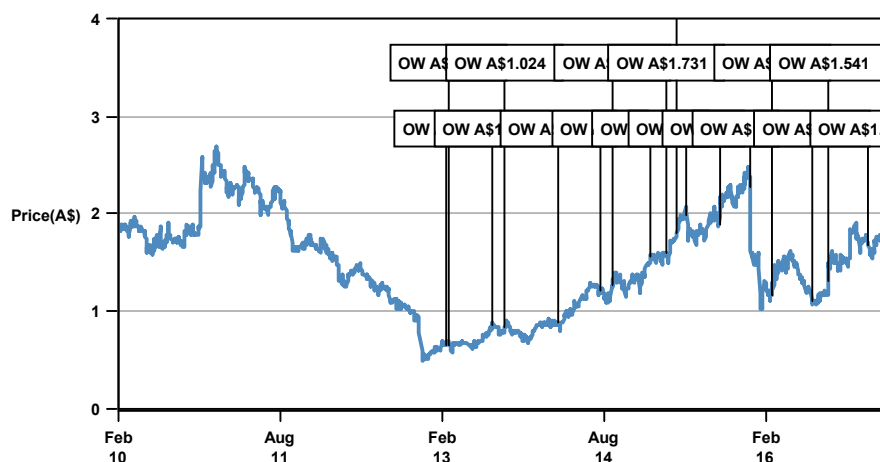
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Austal Limited (ASB.AX, ASB AU) Price Chart



Date	Rating	Share Price (A\$)	Price Target (A\$)
13-Feb-13	OW	0.66	0.96
22-Feb-13	OW	0.66	0.94
18-Jul-13	OW	0.87	1.03
30-Aug-13	OW	0.84	1.02
27-Feb-14	OW	0.88	1.11
18-Jul-14	OW	1.22	1.20
27-Aug-14	OW	1.27	1.48
08-Jan-15	OW	1.56	1.59
27-Feb-15	OW	1.59	1.73
02-Apr-15	OW	1.82	1.82
07-May-15	OW	1.99	1.96
27-Aug-15	OW	1.88	1.96
10-Dec-15	OW	2.28	1.91
23-Feb-16	OW	1.17	1.89
04-Jul-16	OW	1.11	1.44
29-Aug-16	OW	1.32	1.54
13-Jan-17	OW	1.68	1.75

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Feb 13, 2013.

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IB clients*	52%	48%	34%
JPMS Equity Research Coverage	43%	50%	7%
IB clients*	67%	61%	43%

*Percentage of investment banking clients in each rating category.

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