

Austal Limited

Result in line, Guiding to Higher Margins + Strong Opportunity Pipeline

ASB reported FY17 underlying EBIT of A\$58.7m, up +19.6% on the pcp, and broadly in line with our forecast of A\$59.2m and company guidance of A\$55-60m. The company has guided to FY18 revenue of A\$1.3-1.4bn, with US shipbuilding margins of 6-8% (previously 5-7%). While the result included a number of one-offs (some taken above and some below the line), the balance sheet remains in a decent position and the company has highlighted an order book as at Jun-17 of A\$3bn (in line with the pcp) as well as a tender pipeline that is largest in the company's history. While tender success (and contract profitability) is not a certainty, we believe the company is very well positioned to win a significant portion of this work over the coming 18 months.

- Result in line, despite contract one-off.** ASB reported FY17 underlying EBIT of A\$58.7m, up +19.6% on the pcp, and broadly in line with our forecast of A\$59.2m and company guidance of A\$55-60m. The company's earnings in the period were impacted by financial performance on the Cape Class Patrol Boat support contract, booking a A\$3.2m provision in FY17 against the remainder of the contract through to Aug-19. A fully franked final dividend of 2.0cps was declared, in line with our 2.0cps forecast, bringing the full-year payout ratio to ~40% of underlying EPS. Given the offshore earnings and limited existing franking credits, dividends in the foreseeable future are expected to be unfranked.
- Near-term pipeline remains robust.** The company currently has an order book of ~A\$3bn (similar to the pcp) and the pipeline of work remains robust, driven by: 1) US Defense: the company expects further LCS order in FY18/19 at normalized profit levels with the US Frigate selection occurring in FY20, 2) Australian Defense: downselect expected in late 2017 and Future Frigate downselect expected in early 2018, 3) Commercial: strongest market conditions globally for almost a decade and 4) Middle East Defense: export opportunities remain in the region.

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

Year-end Jun (A\$)	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue (A\$ mn)	1,511	1,324	1,346	1,202	1,229
EBITDA (A\$ mn)	79	90	92	91	93
Net Profit (A\$ mn)	(84)	15	35	35	39
EPS (A\$)	(0.24)	0.04	0.10	0.10	0.11
P/E (x)	NM	38.8	16.9	17.0	15.2
EV/EBITDA (x)	7.2	7.3	7.2	6.7	6.1
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\$)	0.10	0.09	0.10	0.10	0.11
Normalised EPS Growth	(23.8%)	(5.9%)	8.1%	(0.6%)	11.4%
Normalised PE	17.2	18.2	16.9	17.0	15.2

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

Overweight

ASB.AX, ASB AU

Price: A\$1.71

Price Target: A\$2.00

Australia

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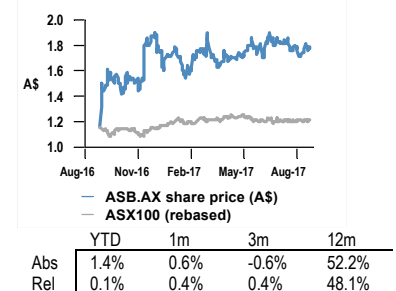
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Price Performance



Company Data

Shares O/S (mn)	349
Market Cap (A\$ mn)	597.60
Market Cap (\$ mn)	474.10
Price (A\$)	1.71
Date Of Price	28-Aug-17
Free Float(%)	-
3M - Avg daily vol (mn)	0.30
3M - Avg daily val (A\$ mn)	0.54
3M - Avg daily val (\$ mn)	0.4
ASX100	4758.80
Exchange Rate	0.79
Price Target End Date	30-Jun-18
Price Target (A\$)	2.00

See page 7 for analyst certification and important disclosures, including non-US analyst disclosures.

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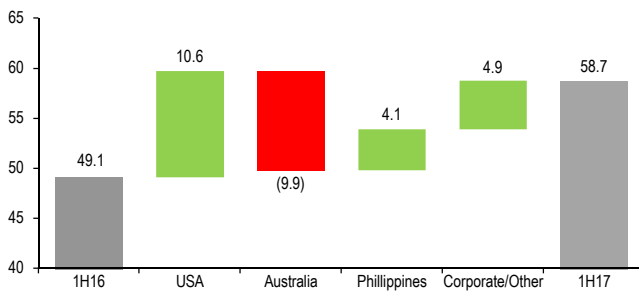
FY17 Results: Charting the Focal Points

US Offsets Australia

ASB reported FY17 underlying EBIT of A\$58.7m, up +19.6% on the pcp, and broadly in line with our forecast of A\$59.2m and company guidance of A\$55-60m. ASB's earnings in the period were impacted by financial performance on the Cape Class Patrol Boat support contract, booking a A\$3.2m provision in FY17 against the remainder of the contract through to Aug-19.

The company is guiding to FY18 revenue of A\$1.3-1.4bn, broadly in line with FY17, with US shipbuilding margins being upgraded slightly to a range of 6-8% (previously 5-7%).

Figure 1: ASB – Underlying EBIT FY17 vs FY16 (A\$m)



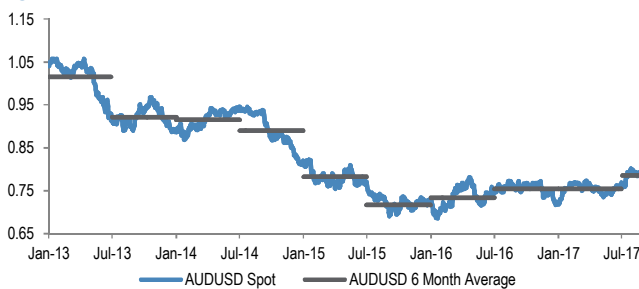
Source: Company reports, J.P. Morgan estimates.

USD 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 dissipated in recent years. The AUD is currently ~4% higher against the USD in 1H18YTD vs FY17.

Figure 3: AUDUSD FX Rate

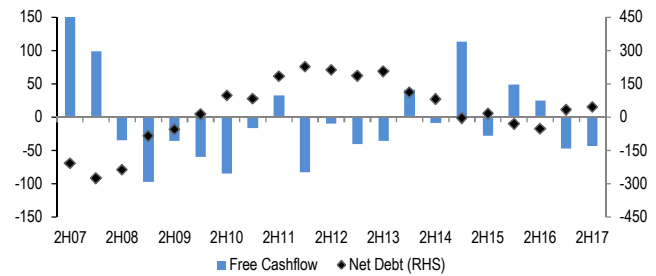


Source: Bloomberg.

Balance sheet remains in good shape

ASB reported operating cashflow of -A\$36.8m, down significantly on the +A\$116.5m reported in the pcp. The company ended the year in a net cash position of A\$19.3m, excluding the impact of the Cape Class Patrol Boats leasing program where the residual value guarantee reduces net cash by A\$65.2m to a net debt position of A\$45.9m. The company expects to enter negotiations which should see this lease arrangement extended and likely reduce or eliminate the residual guarantee.

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

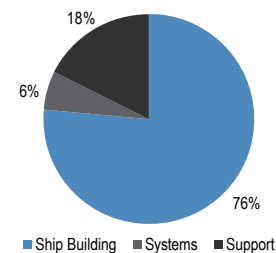


Source: Company reports.

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 FY17, shipbuilding still contributed ~76% of group EBIT (ex Other) on an underlying basis, with the vast majority coming from the US. In FY17, ASB's Support business only contributed ~18% 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 – FY17 Segment EBIT Contribution



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

ASB reported FY17 underlying EBIT of A\$58.7m, up +19.6% on the pcp, and broadly in line with our forecast of A\$59.2m and company guidance of A\$55-60m. Reported NPAT at A\$15.4m was well below our A\$25.8m forecast, with the result impacted by one-off tax items which were not in our forecasts.

A fully franked final dividend of 2.0cps was declared, in line with our 2.0cps forecast, bringing the full-year payout ratio to ~40% of underlying EPS. Given the offshore earnings and limited existing franking credits, dividends in the foreseeable future are expected to be unfranked.

Table 1: ASB – Financial Summary

A\$ in millions

	1H16	2H16	FY16	1H17	2H17	FY17	1H on 1H	% Change 2H on 2H	FY on FY
Revenue	757.7	753.4	1,511.1	657.6	666.5	1,324.1	-13.2%	-11.5%	-12.4%
Operating Costs	(716.0)	(716.2)	(1,432.2)	(611.1)	(622.7)	(1,233.8)	-14.6%	-13.1%	-13.9%
EBITDA	41.8	37.2	79.0	46.5	43.8	90.3	11.2%	18.0%	14.4%
% EBITDA Margin	5.5%	4.9%	5.2%	7.1%	6.6%	6.8%	1.55ppt	1.64ppt	1.60ppt
Share of JV Income	0.0	0.0	0.0	0.0	(0.1)	(0.1)	na	na	na
Depreciation & Amortisation	(12.7)	(17.2)	(29.9)	(15.2)	(16.3)	(31.5)	19.6%	-5.1%	5.4%
EBIT	29.0	20.0	49.1	31.2	27.5	58.7	7.5%	37.2%	19.6%
% EBIT Margin	3.8%	2.7%	3.2%	4.7%	4.1%	4.4%	0.92ppt	1.46ppt	1.19ppt
Net Interest Expense	(2.3)	(3.2)	(5.5)	(3.0)	(2.6)	(5.7)	32.9%	-17.9%	3.2%
Profit Before Tax	26.8	16.8	43.6	28.2	24.8	53.0	5.4%	47.8%	21.7%
Tax Expense	(9.9)	1.2	(8.8)	(9.6)	(10.7)	(20.4)	-3.0%	-1028.3%	131.5%
Outside Equity Interest	(0.1)	0.0	(0.1)	0.0	0.0	0.0	-100.0%	na	-100.0%
Profit After Tax Before Sig Items	16.7	18.0	34.7	18.6	14.1	32.7	11.0%	-21.4%	-5.8%
Pre Tax Significant Items	0.0	(169.9)	(169.9)	(13.2)	0.0	(13.2)	na	-100.0%	-92.3%
Tax Expense	0.0	51.0	51.0	3.9	(8.1)	(4.2)	na	-115.9%	-108.1%
Reported NPAT	16.7	(101.0)	(84.3)	9.3	6.0	15.4	-44.1%	-105.9%	-118.2%
Reported EPS	4.7¢	(29.0¢)	(24.2¢)	2.6¢	1.8¢	4.4¢	-44.2%	-106.1%	-118.2%
Normalised EPS	4.7¢	5.2¢	10.0¢	5.3¢	4.1¢	9.4¢	10.9%	-21.1%	-5.9%
DPS	2.0¢	2.0¢	4.0¢	2.0¢	2.0¢	4.0¢	0.0%	0.0%	0.0%

Source: Company reports.

Divisional Summary

United States

Table 2: ASB – United States Financial Summary#

A\$ in millions

	1H16	2H16	FY16	1H17	2H17	FY17	1H on 1H	% Change 2H on 2H	FY on FY
Revenue*	638.4	650.5	1,289.0	594.3	577.8	1,172.1	-6.9%	-11.2%	-9.1%
EBIT	26.9	38.6	65.5	41.1	34.9	76.1	53.0%	-9.5%	16.1%
% EBIT Margin	4.2%	5.9%	5.1%	6.9%	6.0%	6.5%	2.71ppt	0.11ppt	1.41ppt

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

The US division reported revenue of A\$1.2bn (FY16: A\$1.3bn), with segment EBIT of A\$76.1m (FY16: A\$65.5m). The result was driven by work on 12 ship construction projects across ASB's two major vessel contracts for the US Navy: the ~US\$4.5bn LCS contract and the ~US\$1.9bn EPF contract.

The US shipbuilding EBIT margin was 6.8%, in line with the company's guidance range of 5-7%. The company has indicated that the turnaround of the LCS program continues and will be further demonstrated when LCS14 is delivered towards the end of CY2017.

Australia

Table 3: ASB – Australia Financial Summary#

A\$ in millions

	1H16	2H16	FY16	1H17	2H17	FY17	1H on 1H	% Change 2H on 2H	FY on FY
Revenue*	95.8	77.8	173.6	40.1	59.6	99.7	-58.2%	-23.4%	-42.6%
EBIT	11.3	(3.4)	7.9	1.7	(3.8)	(2.1)	-84.6%	10.3%	-126.2%
% EBIT Margin	11.8%	-4.4%	4.5%	4.4%	-6.4%	-2.1%	-7.45ppt	-1.95ppt	-6.59ppt

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

The Australian division reported revenue of A\$99.7m (FY16: A\$173.6m), with a segment EBIT of -A\$2.1m (FY16: A\$7.9m). Revenue in the division has now slumped to a five-year low as the business transitions between programs. ASB's earnings in the period were impacted by financial performance on the Cape Class Patrol Boat support contracting booking a A\$3.2m provision in FY17 against the remainder of the contract through to Aug-19. Additionally, the Patrol Boat charter program only generated limited earnings in FY17 and a full-year contribution in FY18 should assist earnings.

Construction work has ramped up into FY18 with the Pacific Patrol Boat program performing in line with schedule and budget. The company has revised its profit recognition process in FY17 and profit from the contract is not expected to be recognized until FY19 when the first vessel is scheduled to be delivered and major risks to the program have been eliminated.

Philippines

Table 4: ASB - Philippines Financial Summary#

A\$ in millions

	1H16	2H16	FY16	1H17	2H17	FY17	1H on 1H	% Change 2H on 2H	FY on FY
Revenue*	11.8	15.3	27.2	12.7	21.0	33.7	7.7%	36.7%	24.1%
EBIT	0.6	(4.3)	(3.8)	(2.8)	3.1	0.3	-591.1%	-172.6%	-108.8%
% EBIT Margin	4.9%	-28.3%	-13.9%	-22.2%	15.0%	1.0%	-27.01ppt	43.29ppt	14.85ppt

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

The Philippines division reported revenue of A\$33.7m (FY16: A\$27.2m), with a segment EBIT of A\$0.3m (FY16: -A\$3.8m). The company changed management in the business in FY17, which assisted in seeing the business return to profitability in 2H17.

Additional vessels remain in the pipeline following the recent award of a A\$108m contract with Fjord line of Norway to design and build a 109m high speed vehicle passenger ferry. The company announced that it expects to expand build and launch facilities to support the Fjord Line vessel and other vessels. This expansion is expected to cost US\$30m.

Earnings Forecasts Revisions

Following the FY17 result, we have adjusted our earnings forecasts as detailed in Table 6:

Table 5: ASB – Earnings Forecasts Revisions

Year to 30 June 2017	Revised	Previous	% Change
EBITDA (A\$m)	90.3	90.6	(0.3%)
NPAT (A\$m)	15.4	25.8	(40.5%)
Norm NPAT (A\$m)	32.7	35.0	(6.7%)
EPS (c)	4.4	7.3	(39.6%)
Norm EPS (c)	9.4	9.9	(5.3%)
DPS (c)	4.0	4.0	0.0%
Year to 30 June 2018	Revised	Previous	% Change
EBITDA (A\$m)	91.6	94.2	(2.7%)
NPAT (A\$m)	35.3	37.7	(6.3%)
Norm NPAT (A\$m)	35.3	37.7	(6.3%)
EPS (c)	10.1	10.6	(4.7%)
Norm EPS (c)	10.1	10.6	(4.7%)
DPS (c)	4.0	4.0	0.0%
Year to 30 June 2019	Revised	Previous	% Change
EBITDA (A\$m)	91.3	75.6	20.8%
NPAT (A\$m)	35.1	27.1	29.4%
Norm NPAT (A\$m)	35.1	27.1	29.4%
EPS (c)	10.1	7.7	31.6%
Norm EPS (c)	10.1	7.7	31.6%
DPS (c)	4.0	4.0	0.0%

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

Investment Thesis, Valuation and Risks

Austal Limited (*Overweight; Price Target: A\$2.00*)

Investment Thesis

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

Valuation

Our June 2018 share price target of A\$2.00 is based on our DCF valuation of A\$1.79 per share (WACC: 9.8%, 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						Valuation Summary					
	FY16	FY17	FY18E	FY19E	FY20E	A\$m		A\$ps			
Revenue	1,511	1,324	1,346	1,202	1,229	Current mkt capitalisation		597.60		1.71	
Revenue growth	5.4%	(12.4%)	1.6%	(10.7%)	2.3%	Price Target				2.00	
COGS	(1,386)	(1,193)	0	0	0	Capital growth to price target				16.8%	
Operating Expenses	(46)	(41)	(1,254)	(1,110)	(1,136)	Trading Multiples					
EBITDA	79	90	92	91	93		FY16	FY17	FY18E	FY19E	FY20E
EBITDA growth	(19.0%)	14.4%	1.5%	(0.4%)	1.9%	PE Pre-abnormals	17.2	18.2	16.9	17.0	15.2
EBITDA margin	5.2%	6.8%	6.8%	7.6%	7.6%	PE Reported	NM	38.8	16.9	17.0	15.2
Amortisation	(1)	(1)	(1)	(1)	(1)	EV/EBITDA	7.2	7.3	7.2	6.7	6.1
Depreciation	(28)	(30)	(30)	(31)	(30)	EV/EBIT	11.5	11.2	11.0	10.3	9.1
EBIT	49	59	60	59	63	Key Ratios					
Other Income	-	-	-	-	-		FY16	FY17	FY18E	FY19E	FY20E
Other Expenses	-	-	-	-	-	Dividend Yield	2.3%	2.3%	2.3%	2.3%	2.3%
Net Interest	(5)	(6)	(7)	(7)	(4)	Franking	100.0%	100.0%	0.0%	0.0%	0.0%
Pre-Tax Profit	44	53	53	53	59	Return on Assets (%)	3.3%	3.3%	3.6%	3.6%	4.1%
Tax	(9)	(20)	(18)	(18)	(20)	Return on Equity (%)	7.1%	7.1%	7.5%	7.2%	7.6%
Tax Rate	20.2%	38.4%	34.0%	34.0%	34.0%	ROIC (%)	6.0%	5.6%	6.0%	5.9%	6.4%
Minorities	(0)	0	0	0	0	Leverage					
Abnormals (post tax)	(119)	(17)	0	0	0		FY16	FY17	FY18E	FY19E	FY20E
Reported NPAT	(84)	15	35	35	39	Gearing (Net Debt / Equity)	(11.3%)	10.0%	10.2%	(0.2%)	(8.5%)
Normalised NPAT	35	33	35	35	39	Gearing (ND / (ND + E))	(12.7%)	9.1%	9.2%	(0.2%)	(9.2%)
Growth	(23.1%)	(5.8%)	8.0%	(0.5%)	11.4%	Net Debt / EBITDA	(65.5%)	50.8%	53.2%	(1.0%)	(47.8%)
End of Period Shares	348	349	350	350	350	EBIT Interest Cover (x)	8.9	10.4	8.6	9.1	17.8
EFPOWA	348	348	348	348	348	Balance Sheet					
Reported EPS (\$)	(0.24)	0.04	0.10	0.10	0.11		FY16	FY17	FY18E	FY19E	FY20E
Normalised EPS (\$)	0.10	0.09	0.10	0.10	0.11	Cash	224	150	150	150	150
Growth	(23.8%)	(5.9%)	8.1%	(0.6%)	11.4%	Receivables	128	100	110	104	106
DPS (\$)	0.04	0.04	0.04	0.04	0.04	Investments	-	-	-	-	-
Growth	0.0%	0.0%	0.0%	0.0%	0.0%	Inventories	109	170	166	155	159
DPS/EPS payout	NM	90.7%	39.4%	39.6%	35.6%	Other Current Assets	8	10	11	11	11
Cash Flow Statement						Total Current Assets	470	432	437	420	426
Net Profit for Cashflow	(121)	59	60	59	63	Net PPE	491	500	523	504	485
Depreciation & Amortisation	30	32	31	32	30	Total Intangibles	9	9	8	8	7
Non Cash Items	-	-	-	-	-	Other Non Current Assets	43	19	30	30	31
Working Capital Changes	213	(108)	5	7	(2)	Total Non Current Assets	543	528	561	541	524
Other Operating Cashflows	(6)	(19)	(33)	(23)	(21)	Total Assets	1,013	960	998	962	950
Cashflow from Operating Activities	117	(37)	64	76	70	Creditors	230	155	166	155	159
Capex	(39)	(10)	(53)	(12)	(12)	Current Borrowings	3	10	10	10	10
Net Acquisitions	0	(45)	0	0	0	Current Tax Provisions	0	0	5	6	7
Other Investing cashflows	0	0	0	0	0	Other Current Provisions	42	47	48	49	51
Investing Cash Flow	(39)	(55)	(53)	(12)	(12)	Other Current Liabilities	32	28	28	28	29
Inc/(Dec) in Borrowings	11	25	3	(50)	(44)	Total Current Liabilities	307	239	257	249	256
Equity Issued	0	0	0	0	0	Non Current Creditors	-	-	-	-	-
Dividends Paid	(16)	(12)	(13)	(14)	(14)	Non Current Borrowings	170	186	189	140	96
Other Financing Cashflows	0	0	0	0	0	Deferred Tax Liabilities	0	11	6	6	6
Financing Cash Flow	(5)	12	(10)	(64)	(58)	Other Non Current Provisions	1	3	3	3	3
Net Cash Flow	69	(74)	0	0	0	Other Non Current Liabilities	78	64	64	64	64
						Total Non Current Liabilities	249	264	262	213	169
						Total Liabilities	556	503	519	462	425
						Equity	115	116	117	117	117
						Other Equity	0	0	0	0	0
						Reserves	101	92	92	92	92
						Retained Profits	242	249	270	291	316
						Outside Equity Interests	0	0	0	0	0
						Total Shareholders Equity	458	457	479	500	525
						Net Debt	(52)	46	49	(1)	(44)

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

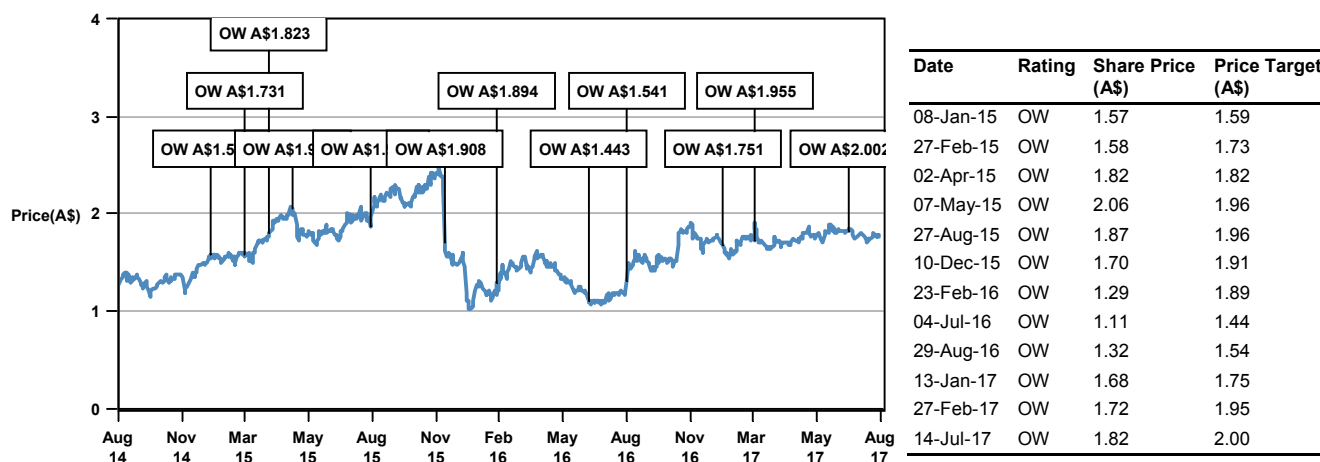
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- **Other Significant Financial Interests:** J.P. Morgan owns a position of 1 million USD or more in the debt securities of Austal Limited.

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



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Feb 12, 2013.

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