October 23, 2019

Singapore Aviation Services

Possible cold snap in autumn

POSITIVE *[Unchanged]*

Some pressure for q/e Sept but drivers intact

The regional trade slowdown, Boeing's B737MAX groundings, Jet Airways' bankruptcy and the Hong Kong unrest present a confluence of factors that could pose pressure points to the q/e Sept results for Singapore aviation services companies. SATS is the most exposed to these factors while ST Eng is the least. That said, we don't expect the current issues to affect medium-term growth strategies or drivers for any of the three companies. Our current order of preference is ST Eng, SATS, SIA Eng.

YTD-Aug aviation stats still a very mixed bag

Visitor arrival growth at 1.9% YTD continues to be mediocre and while Chinese visitors are increasing again, ASEAN and India (c42% of total) have contracted YTD. Changi passenger traffic saw a better 3.6% growth for the same period but air cargo volumes continued falling on a slippery slope, down YoY for the tenth consecutive month. Flight volumes fell a modest 0.9% but largely due to the lower cargo volumes, we believe.

Medium-term drivers should see little impact

We forecast a 3-year PATMI CAGR of 10% for SATS driven by new central kitchens in China, India and expansion into new cargo markets in Asia Pacific. We expect ST Eng's 16% PATMI CAGR outlook to be driven by new large acquisitions, like MRAS, Smart City solutions growth and a recovery in Marine profits from the recently awarded US Navy contract. Our outlook for SIA Eng growth is a more muted 7% CAGR, driven largely by cost control and efficiency initiatives starting to show results augmented by some diversification initiatives in cabin interior parts manufacturing and inflight entertainment connectivity MRO.

ST Eng most preferred; SIA Eng least

ST Eng is our most preferred in the sector. While it currently offers a lower potential return than SATS, it is also relatively insulated from short-term fluctuations in passenger, cargo volumes and flight frequency. SATS is our next preferred – YTD relative stock price performance has no doubt been weighed by collapsing Singapore and Hong Kong cargo data but investors should also bear in mind some mitigating factors of new cargo terminals in Damman, Mumbai, ground handling JV with AirAsia (AAGB MK; CMP MYR1.91; TP MYR 1.56; Sell) and a ramp up of China central kitchens. And while SIA Eng stock has been the best performer, it has been largely fuelled by potential privatization talk on the street; on the operational front there has been little to surprise us on the upside in recent quarters and we believe the growth initiatives could take another 2-4 quarters to start showing through.

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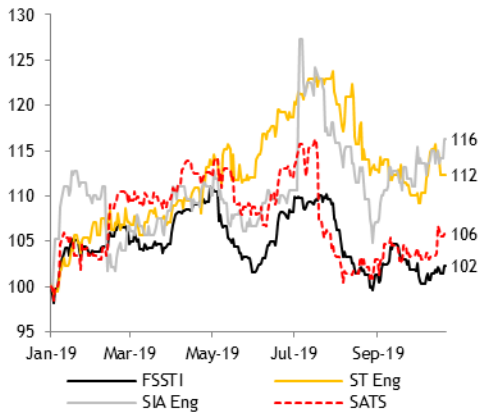
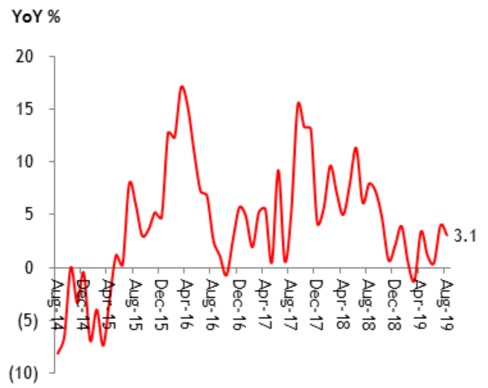
Fig 1: YTD rel. price performance



FactSet (Re-based 100 at Jan 1, 2019)

Fig 2: Singapore visitor arrival growth



Source: CEIC, Maybank Kim Eng

Stock	Bloomberg code	Mkt cap (USD'm)	Rating	Price (LC)	TP (LC)	Upside (%)	P/E (x) 19E	P/E (x) 20E	P/B (x) 19E	P/B (x) 20E	Div yld (%) 19E	Div yld (%) 20E
ST Engineering	STE SP	8,968	Buy	3.92	4.50	15	20.0	16.8	4.6	4.3	4.0	4.8
SATS	SATS SP	4,052	Buy	4.92	6.10	24	23.6	20.2	3.5	3.2	3.7	4.1
SIA Engineering	SIE SP	2,133	Buy	2.59	2.85	10	17.3	17.2	1.8	1.9	4.5	4.6

SEE PAGE 8 FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

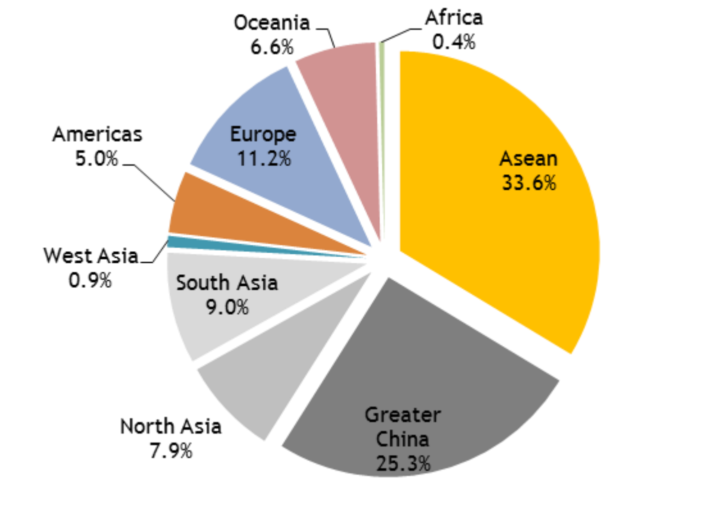
Jan-Aug 2019 aviation stats: a very mixed bag

Visitors: China is back but notably ASEAN, India missing

Singapore inbound visitors grew 3.1% YoY in August and 1.9% YTD. Monthly visitor data for most regions has been generally weak. Read-throughs worth highlighting for the four largest inbound visitor blocs are:

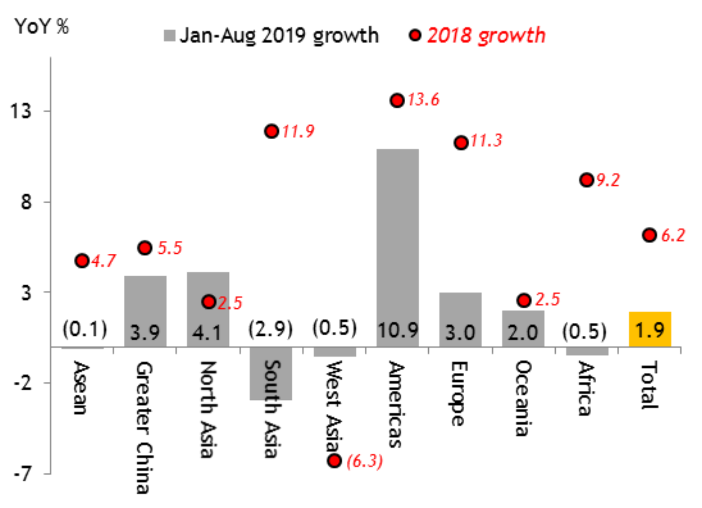
- **Greater China:** After the sharp declines in Oct 2018-Feb 2019, Chinese visitor arrivals have returned to growth of 2.6%-7% YoY since March. We believe this is in part due to Singapore benefiting from some Chinese tourist diversion from Hong Kong and hence also uncertain if the growth can be sustained once Hong Kong returns to normalcy.
- **ASEAN:** YTD visitor arrival fell marginally. Largest visitor groups Indonesia and Malaysia (c60% of ASEAN) contracted c0.5% YoY and visitors from Thailand are down a material 5.4% YoY. We think this is likely a reflection of the current weakness in these regional economies curbing discretionary spending.
- **Europe:** YTD visitor growth was a reasonable 3% YoY but tepid in the context of the c7-11% annual growth witnessed in the past three years. UK, the largest within Europe, grew 3.6% and Germany, the second largest, grew 9.8% but other countries were mostly flat to down.
- **South Asia:** YTD visitor growth fell 2.9% YoY. India, which accounts for c80-85% of South Asia visitors, was down 2% YoY, extremely weak in context of the c8-15% annual growth in the past three years.

Fig 3: Jan-Aug 2019 Singapore visitor arrivals by region



Source: CEIC, Maybank Kim Eng

Fig 4: Jan-Aug Singapore visitor growth by region



Source: CEIC, Maybank Kim Eng

Changi Pax: Driven by growing fleets, airport expansion

SATS is exposed to Changi passenger volumes; ST Eng and SIE have no direct exposure to Changi passenger volumes

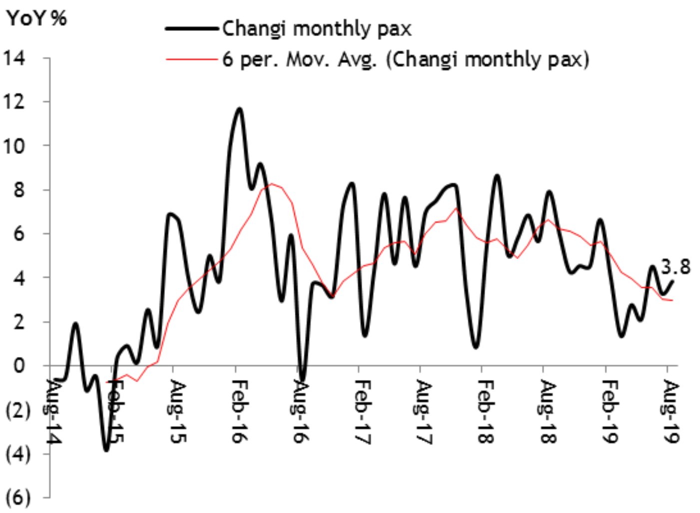
Despite the tepid visitor arrivals numbers into Singapore, total passenger throughput at Changi continued to grow at a healthy pace with August posting 3.8% YoY and YTD growth at 3.6%. This is a positive for the aviation services companies.

While the market monitors visitor growth for a read-through to the Singapore tourism sector and hotel room rates etc, we stated previously that for Singapore aviation services, Changi passenger and flight volume is a more important metric to monitor (as transit passengers eat in-flight meals and transit aircraft require ground-handling services too).

Changi's Terminal 4 expansion in late-2017, which increased the airport's annual passenger handling capacity from c65m to 85m, has been instrumental in capturing a share of growing transit traffic from LCC fleet growth in the region.

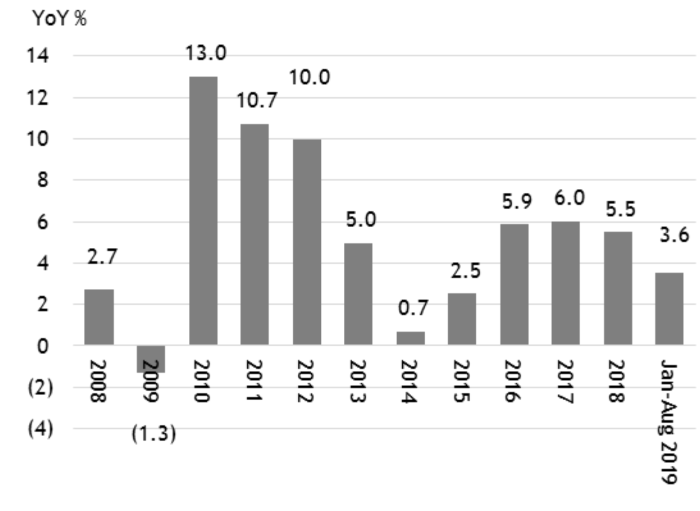
In the q/e Sept alone, some of the material developments boosting connectivity through Changi were IndoGo increasing weekly flight frequency, Vistara and Urumqi Air launching flights to Singapore, and Easyjet Air and Jeju Air adding weekly services for Busan-Singapore.

Fig 5: Monthly Changi passenger throughput growth



Source: CEIC, Maybank Kim Eng

Fig 6: Annual Changi passenger throughput growth



Source: CEIC Maybank Kim Eng

Changi air cargo: Still on a slippery slope

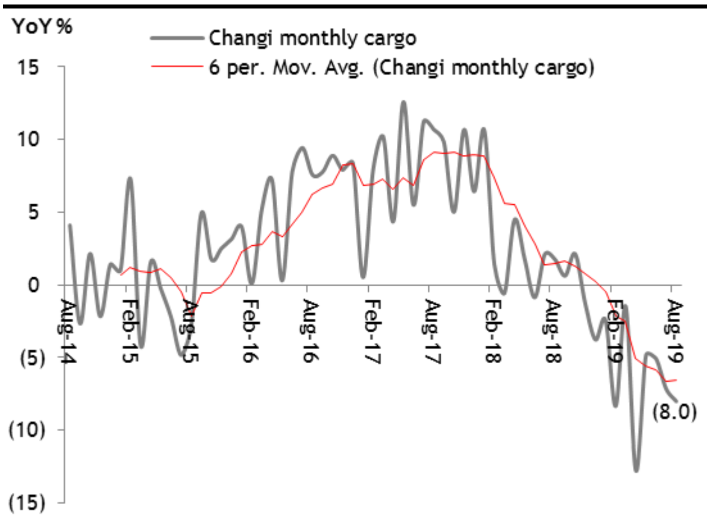
August air cargo throughput through the Changi hub fell 8% YoY (July: 7.2%), registering its tenth consecutive month of contraction. Jan-Aug 2019 registered a decline of 6.2%, the worst since the GFC period in 2008-2009.

SATS is exposed to cargo volumes in Changi and HKIA (amongst other cities in Southeast Asia and the Middle East); ST Eng and SIE have no direct exposure to cargo volumes

SATS is exposed to cargo volumes at Changi through its exposure from managing one of Changi's cargo terminals and we estimate this accounts for c7% of gateway revenues at most.

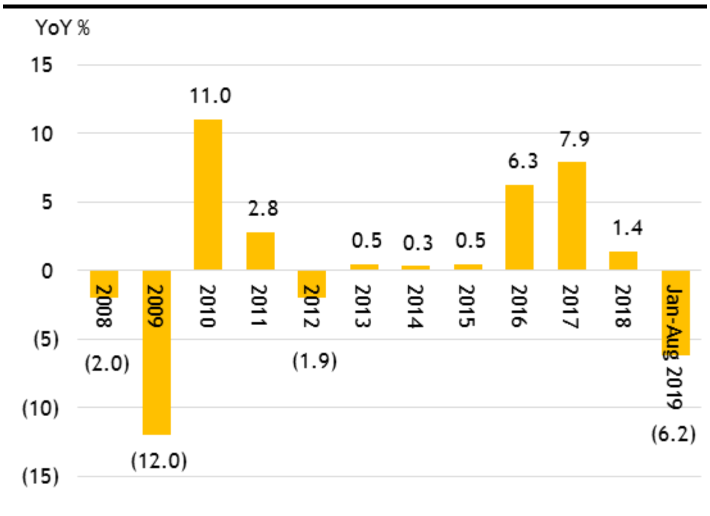
It also has a 45% associate stake in Asia Airfreight Terminals (AAT), one of Hong Kong International Airport's (HKIA) three air cargo terminals. Hong Kong air cargo volumes have been suffering as well due to the trade war, exacerbated in recent months by the civil unrest. We estimate Jan-Aug 2019 cargo volumes were down YoY approximately 7.5-8% as well.

Fig 7: Monthly Changi air cargo growth



Source: CEIC, Maybank Kim Eng

Fig 8: Annual Changi air cargo growth



Source: CEIC, Maybank Kim Eng

Changi flight frequency: Affected by cargo decline

SATS and SIE are exposed to Changi flight frequency; STE has no direct exposure to Changi flight frequency

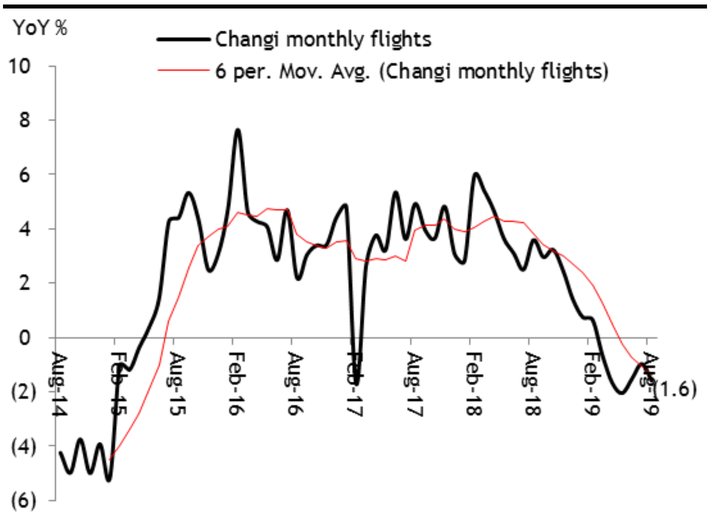
Commercial flight volumes at Changi were down 1.6% YoY in August, while YTD it fell 0.9%.

The data granularity does not separate passenger versus cargo aircraft but we expect this decline was largely driven by lower cargo freighter flight frequency given fall in cargo volumes (we estimate around 10-12% of commercial flights through Changi to be freighters).

Although to a must lesser degree, another possible headwind to flight volume growth in the near term could be capacity up-gauging with new aircraft on medium and long haul routes. For example, the new Airbus A350XWB, which many airlines would consider as a replacement for the ageing A330-300, has around 20-25% higher seating capacity.

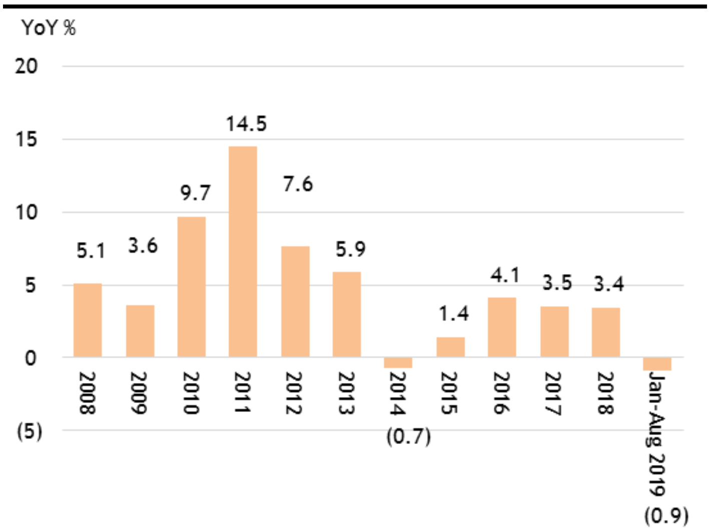
OEM delivery schedules indicate a net c2% increase in APAC passenger aircraft fleet in 2019, driven by a c12% net fleet increase for the region's LCCs.

Fig 9: Monthly Changi commercial flights growth



Source: CEIC, Maybank Kim Eng

Fig 10: Annual Changi commercial flights growth



Source: CEIC, Maybank Kim Eng

Possible cold snap in autumn

Some potential pressure points for q/e Sept…

We think there are three key areas that might pose some risk to our as well as market expectations in the upcoming results season:

- **Air cargo contraction:** SATS is exposed to cargo volumes in Changi and HKIA (amongst other cities in Southeast Asia and the Middle-East); ST Eng and SIE have no direct exposure to cargo volumes. Singapore manufacturing slowdown and air cargo volume declines have been well publicized since the beginning of the US-China trade war last year and should pose limited scope for surprises. It is SATS' Hong Kong associate investment operations that may pose a wild card. YTD-Aug air cargo volumes at HKIA were down an estimated 7.5-8% YoY (11.5% YoY in August). Sept data has not been released yet. Moreover AAT is the smallest of the three cargo terminals at HKIA and could potentially be squeezed in terms of market share too.
- **Boeing B737MAX groundings:** To mainly affect SIA Eng and, SATS to a lesser degree. SIA Eng's parent Singapore Air (SIA SP; CMP SGD9.04; TP SGD11.20; BUY) operates six B737MAX and two B787—10 aircraft which have been grounded. For line maintenance firms, apart from loss of line maintenance for B737MAX aircraft, the groundings are also prolonging maintenance cycles for rest of the airline fleets.
- **Jet Airways bankruptcy:** To affect ST Eng and SATS this quarter from a revenue loss standpoint. For ST Eng, there are no receivables issues from the Jet Airways bankruptcy, and the cUSD350m in MRO orders has already been taken out of its balance order book. But the workshop facility that was being used for servicing Jet Airways engines is now idle and it's likely to take some quarters to fill up with new jobs. For SATS, Jet Airways used to operate c9 flights/day and management stated that with the SGD3.3m provision in 1Q20, 100% of Jet Airways receivables have been provisioned for.

…but medium-term growth drivers unchanged

We believe Singapore's aviation services firms are better equipped to deal with visitor, passenger volatility in Singapore than other tourism-related segments such as hospitality, retail and entertainment etc.

This is primarily so as all three companies are quite diversified both geographically with overseas operations that we estimate contribute c10-40% of profits and in terms of service offerings.

A recent case to point this resilience would be SATS gateway services revenue growth in the last reported q/e June 2019 of 12% versus an air cargo volume contraction at Changi of 7.6% during the same period.

As highlighted on the front page, we don't expect the various factors that could potentially pose pressure points for the q/e Sept results to have any material impact on our forecast 3-year PATMI CAGR drivers for the three companies.

ST Eng, SATS, SIA Eng is our current order of preference

Q/e Sept PATMI expectations

Our q/e Sept PATMI expectations are cSGD150m for ST Eng, cSGD61m for SATS and cSGD40m for SIA Eng.

Bloomberg consensus PATMI expectations for the quarter are SGD137m for ST Eng and SGD61m for SATS. There are no consensus numbers available for SIA Eng.

Key risks to our positive view

Some of the key downside risks to our positive thesis, stock picks, forecasts and valuation estimates are:

i) intensifying price competition from smaller players struggling with excess capacity;

ii) OEMs getting aggressive in expanding in aftermarket MRO;

iii) a significant and prolonged contraction in air traffic, triggered by pandemic events, like avian-flu and SARS, etc.;

iv) a sharp rise in labour costs, driven by unforeseen events (as was the case during the Middle-East conflict during the last decade);

v) poorly executed acquisitions (in particular ST Eng and SATS are quite active with acquisitions);

vi) significant and prolonged disruption to airborne cargo growth, driven by the US-China trade war affecting SATS' cargo operations and ST Eng.'s aircraft conversion business.

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