

# Singapore Industry Focus Shipbuilding

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DBS Group Research . Equity

1 Feb 2019

## Merger on the cards ?

- Hyundai signs MOU to acquire Daewoo to create global shipbuilding powerhouse
- Reduces competition; positive for newbuild prices
- News to reignite speculation on yard mergers in Singapore and China
- BUY Sembcorp Marine (SMM) and Yangzijiang

**HHI+DSME = shipbuilding powerhouse.** Hyundai Heavy Industries (HHI) has signed a conditional MOU with Korean Development Bank (KDB) to take over the latter's 55.7% stake in DSME in a share-swap deal. If this goes ahead, the combined entity will command >20% market share of global shipbuilding backlog.

### Yard mergers on the cards in China and Singapore too?

The Korean yard merger substantiates our thesis of continued consolidation in the shipbuilding sector. Recall that the Chinese government reportedly approved the merger of its two largest SOE yards – CSIC and CSSC – last year, but there have been no update since. A similar speculation for Singapore rigbuilders could also be reignited. We believe consolidation will accelerate industry recovery, phasing out excess capacity, alleviate competition, and boost pricing power eventually.

**Buy the beneficiaries of industry consolidation.** In the event of a merger speculation, **SMM (TP S\$2.40; +50%)** could re-rate on anticipation of it being a privatisation / takeover target. In any case, we believe the current level is a good entry point for SMM as: 1. We expect management tone to turn more positive as activity level, revenue and profitability are trending up; 2) optimism on new contracts for production platform in particular FPSOs for Brazil; 3) M&A angle.

**Yangzijiang (TP S\$1.82; +30%)** is a prime beneficiary of industry consolidation and shipbuilding recovery. Its move into the LNG carrier space through partnership with Japanese yard Mitsui will pave their way into a new market. In addition, the stock offers a decent 3.5% dividend yield.

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|                          | Price<br>S\$ | Mkt Cap<br>US\$m | 12-mth              |                                 | Rating |
|--------------------------|--------------|------------------|---------------------|---------------------------------|--------|
|                          |              |                  | Target Price<br>S\$ | Performance (%)<br>3 mth 12 mth |        |
| Keppel Corporation       | 6.10         | 8,206            | NR                  | (2.4) (30.4)                    | NR     |
| Sembcorp Industries      | 2.59         | 3,431            | 3.70                | (8.8) (24.9)                    | BUY    |
| Sembcorp Marine          | 1.60         | 2,480            | 2.40                | (0.6) (36.8)                    | BUY    |
| Yangzijiang Shipbuilding | 1.40         | 4,100            | 1.82                | 10.2 (11.4)                     | BUY    |

Source: DBS Bank, Bloomberg Finance L.P.

Closing price as of 31 Jan 2019

**Time to reform, restructure and reposition**

- We expect positivity of a merger of Top Oilst and Shell
- **SCI could re-rate if it divests Shell**
- **Keppel could swap infrastructure assets for SCI's stake in Shell**
- **Upgrade Keppel Corp to BUY (TP S\$7.00), raised target price for SCI (BUY; TP S\$4.10) and SMM (BUY; TP\$2.30)**

**Is it time to restructure?** The possibility of M&A between the two Singapore conglomerates – Keppel Corporation (Keppel) and Sembcorp Industries (SCI), has resurfaced. This was prompted by growing challenges in the offshore and marine sector and recent changes in the leadership of these groups. In this report, we attempt to explore the possible scenarios for reallocation of the O&M assets involving Keppel, SCI and its listed subsidiary Sembcorp Marine (SMM).

**We identified three concrete scenarios:**

1. **Creating a Global Power House:** A merger of Keppel Offshore & Marine (Keppel O&M) and SMM would combine their core competencies and world-class facilities, thus strengthening their franchise and creating room for further cost rationalisation.
2. **SCI's possible divestment of SMM could unlock value for shareholders:** SCI could enhance value to its shareholders by focusing on its core competency along the utilities value chain, and divesting SMM to Keppel, Temasek or ST Engineering.
3. **Keppel to inject infrastructure assets into SCI:** Keppel could remain a conglomerate but swap its infrastructure assets (worth c.S\$1.3bn, and are strategic to SCI), for SCI's interest in SMM.

**Position for global champions:** Share prices have formed a base and we anticipate positioning into these stocks, on a potential M&A to better order flow as shipyards are diversifying into non-shipping and M&P projects and if trade on oil price recovery. We raised **SMM's** valuation peg from 1.2x to 1.5x (a 25% increase of share price from **US\$1.40 to US\$1.82** higher TP). We are also lifting the valuation peg for Keppel's commodity segment from 0.85x to 1.0x (a 15% pushing its TP to S\$7.00).

**Upgrade Keppel to BUY:** We believe SCI could emerge as a clear winner in this scenario with potential re-rating of its utilities business; SMM benefits as a pure play to ride on sector recovery. Keppel to tap on the re-rating of property sector in the near term.

**Asset swap scenario:** A diagram showing the exchange of assets between Keppel and Sembcorp Marine, resulting in Keppel Corporation and Sembcorp Industries.



**What is happening?**

Hyundai Heavy Industries (HHI), the world’s largest shipbuilding company, **has indicated interest in acquiring its rival**, the second largest Korean shipbuilder - Daewoo Shipbuilding & Marine Engineering Co., Ltd (DSME).

HHI has signed a conditional MOU with Korean Development Bank (KDB) to take over the latter’s 55.7% stake in DSME via the issue of matching convertible preferred stocks and common shares in merged entity. The deal includes KDB’s liquidity support of 2.5 trillion won (US\$2.25bn) for DSME.

KDB said it would also approach Korea’s third largest shipbuilding company - Samsung Heavy Industries Co Ltd (SHI) - to gauge any interest in taking over DSME.

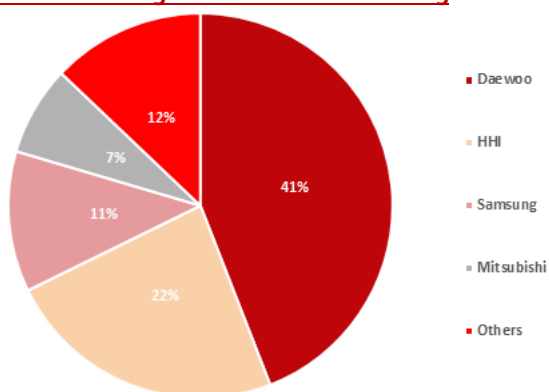
**What is the rationale?**

The move comes amid **growing calls the reform the Korean shipbuilding industry** from the current big three— HHI, DSME and SHI— to two, to enhance **competitiveness against global competitors from China and Singapore** such as China State Shipbuilding (CSSC), China Shipbuilding Industry (CSIC), Sembcorp Marine (SMM).

The merger of HHI+DSME seems to make more sense than SHI+DSME given the overlap in HHI’s and DSME’s shipbuilding products in particular liquefied natural gas (LNG) ships, very large crude carriers (VLCCs) and naval vessels, as SHI is more focused on offshore projects.

Additionally, we believe one of the chief reasons for HHI’s interest in Daewoo is attributable to Daewoo’s global leadership in LNG carriers. Growing dependence on natural gas and elevated global LNG trade would drive new orders in the future.

**Breakdown of global LNG carrier backlog**



Source: Bloomberg Finance L.P.

**What is the impact?**

HHI+DSME = **shipbuilding powerhouse**. If merged, the combined entity will boast a combined shipbuilding backlog of ~US\$49bn, dwarfing all other players in the industry with >20% market share.

**Lift in newbuild prices**. Industry consolidation helps to trim excess capacity, alleviate competition and translate into stronger pricing power for the survivors. In this case, DSME has historically been very aggressive in their pricing strategy in order to fill the yards. The merger should lift newbuild prices, in particular Korean dominated products, moving forward.

This event **substantiates our thesis of continued consolidation in the shipbuilding sector**. Recall the Chinese government reportedly approved the merger of the two largest SOE yards – CSIC and CSSC - last year, but there have been no updates since. There was also similar speculation for Singapore rigbuilders early last year.

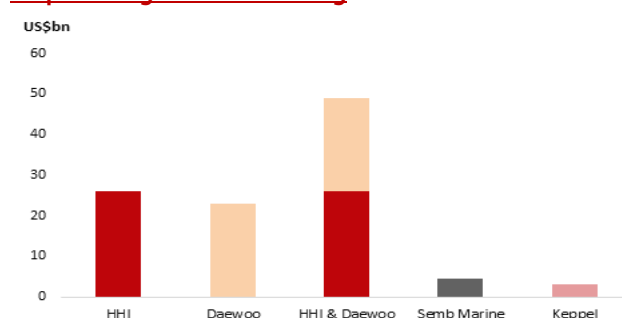
**Could a merger of Singapore rigbuilders be on the cards?**

**Singapore rigbuilders merger speculation resurfaces...**

Following news of the merger of CapitaLand and Ascendas Singbridge on 14 Jan 2019, and now HHI+DSME, there could be renewed speculation of a merger between SMM and KOM. We did a scenario analysis on this in our thematic report dated 20-Jul-2017 Asian Insights SparX: [Shipyards: Creating Global Champions](#)

Merger of KOM and SMM could bring capacity and revenue closer to Korean peers. To get a sense of this, HHI, DSME and SHI secured ~US\$10.2bn, US\$7.3bn and US\$6.3bn new contracts last year, driven by orders for LNG carriers, vs Singapore yards where KOM and SMM clinched US\$1.3bn and US\$0.7bn respectively.

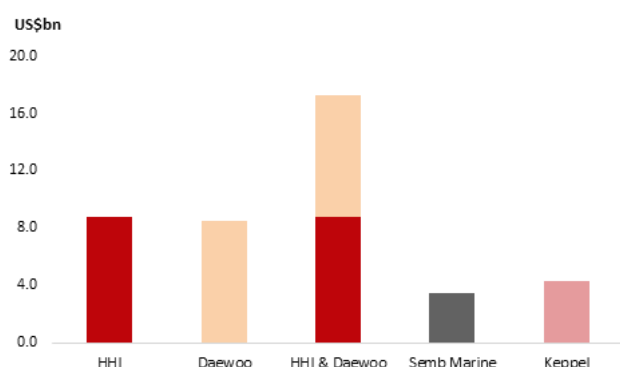
**Shipbuilding contract backlog**



Note: Apart from SMM (dated Sep-18), all the figures in the above chart are as at Dec-18.

Source: Companies

### Shipbuilding revenue comparison (12-month trailing)



Source: Companies

### Recommendations

In the event of merger speculation, **SMM (TP S\$2.40; +50%) could re-rate** on anticipation of it being a privatisation / takeover target. In any case, we believe the current share price is a good entry point for SMM as: 1. We expect management tone to turn more positive as activity level, revenue and profitability are trending up; 2) optimism on new contracts for production platform in particular FPSOs for Brazil; 3) M&A angle.

**Yangzijiang (TP S\$1.82; +30%)** is a prime beneficiary of industry consolidation and shipbuilding recovery. Its move into LNG carrier space through partnership with Japanese yard Mitsui will pave their way into the new market. In addition, the stock offers a decent 3.5% dividend yield.

### Global shipyards comparison

| Company                               | Last Px (LC) | Market cap (US\$m) | P/E FY18F | P/E FY19F | P/B Current | ROE (%) FY18F | ROE (%) FY19F | Net D/E Current | Div Yld (%) Current |
|---------------------------------------|--------------|--------------------|-----------|-----------|-------------|---------------|---------------|-----------------|---------------------|
| <b>Singapore</b>                      |              |                    |           |           |             |               |               |                 |                     |
| Keppel Corp*                          | 6.1          | 8,212              | 11.0      | 9.5       | 1.0         | 8.3%          | 9.1%          | 0.47            | 4.8%                |
| Sembcorp Industries                   | 2.59         | 3,433              | 14.7      | 10.6      | 0.8         | 4.7%          | 6.2%          | 0.86            | 1.5%                |
| Sembcorp Marine                       | 1.6          | 2,482              | nm        | 160.0     | 1.4         | -4.1%         | 0.7%          | 1.11            | 0.6%                |
| Yangzijiang                           | 1.4          | 4,103              | 9.3       | 9.8       | 0.8         | 10.9%         | 9.7%          | CASH            | 3.2%                |
| <b>China</b>                          |              |                    |           |           |             |               |               |                 |                     |
| China Shipbuilding Industry Co (CSIC) | 4.3          | 14,682             | 65.2      | 47.8      | 1.2         | 2.4%          | 3.1%          | CASH            | 0.3%                |
| Shanghai Zhenhua Heavy Industries     | 3.22         | 2,260              | 37.9      | 21.5      | 1.1         | 2.7%          | 4.8%          | 1.81            | 1.3%                |
| China CSSC                            | 12.39        | 2,548              | 49.2      | 41.0      | 1.1         | 2.8%          | 3.1%          | 0.27            | nm                  |
| <b>Korea</b>                          |              |                    |           |           |             |               |               |                 |                     |
| Hyundai Heavy Industries              | 138,500      | 8,811              | nm        | 25.0      | 0.8         | 0.5%          | 3.0%          | 0.09            | nm                  |
| Samsung Heavy Industries              | 9,100        | 5,153              | nm        | 44.4      | 0.8         | -0.2%         | 1.8%          | 0.52            | nm                  |
| Daewoo Shipbuilding                   | 37,000       | 3,566              | 13.0      | 17.8      | 1.1         | 9.0%          | 5.5%          | 1.12            | nm                  |
| <b>Average:</b>                       |              |                    | 52.1      | 38.7      | 1.0         | 3.7%          | 4.7%          | 0.78            | nm                  |
| <b>Median:</b>                        |              |                    | 26.3      | 23.2      | 1.0         | 2.8%          | 4.0%          | 0.69            | nm                  |

\* based on consensus

Source: DBS Bank, Bloomberg Finance L.P.

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**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

**FULLY VALUED** (negative total return i.e. > -10% over the next 12 months)

**SELL** (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

*Share price appreciation + dividends*

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