Singapore Industry Focus

Singapore Aviation Sector

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DBS Group Research . Equity

10 Mar 2023

Flying under investors' radars

- Aviation sector underperformed the market in the past month after mixed earnings performance
- Earnings outlook for the sector remains upbeat; earnings inflection imminent for STE and SIAEC
- Time to go long as improving fundamentals yet to be reflected in share prices and valuations
- STE and SIA are our top picks in the sector

Upbeat on sector's earnings prospects despite macroeconomic concerns. Our optimistic outlook on the aviation sector was reinforced by the latest earnings season, which saw a noticeable change in the tone of management commentary, and companies expressing more optimism on the recovery trajectory. Singapore Airlines' (SIA) impressive earnings momentum appears to be sustainable for a while, while ST Engineering (STE) and SIA Engineering (SIAEC) are well-positioned to see an inflection in earnings as MRO demand accelerates with airlines eager to clear the backlog of deferred maintenance and the normalisation of global flight activity. Although investors may be wary of the sector due to its high sensitivity to changes in macroeconomic growth outlook amid tightening financial conditions, we remain constructive due to the nascent recovery in Asia Pacific and promising forward booking data. With several tailwinds in play, we are confident that the sector will deliver strong earnings growth over the next few years.

Current share price levels are attractive entry points with favourable risk-to-reward. SIA aside, the performance of Singapore aviation counters has fallen behind the broader market over the past six months primarily due to underwhelming earnings. We believe that this is unwarranted and suggest that investors should not be deterred by this quarter's results, as the earnings outlook for the sector remains promising. Additionally, we see buying opportunities as valuations are now more enticing following the share price corrections in the past month. **STE is our preferred choice in the sector**, with the group's earnings expected to grow at a solid 14% CAGR over the next two years, and undemanding valuation at a forward P/E of 18.6x, which is at around the -1.2 standard deviation level. **Additionally, we also like SIA**, as the airline's valuation remains undemanding, and we believe that the street is still severely underestimating the airline's earnings potential. **SIAEC should make a strong comeback to profitability from 1HFY24,** but our optimism towards the stock is somewhat tempered due to its valuation compared to industry peers.

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STOCKS

	Price S$	Mkt Cap US$m	12-mth Target Price S$	Performance (%) 3 mth	12 mth	Rating
ST Engineering	3.42	7,865	4.20	2.7	(15.1)	BUY
Singapore Airlines	5.78	12,687	6.80	4.0	18.7	BUY
SIA Engineering	2.26	1,874	2.80	(3.4)	6.1	BUY

Source: DBS Bank, Bloomberg Finance L.P.
Closing price as of 9 Mar 2023

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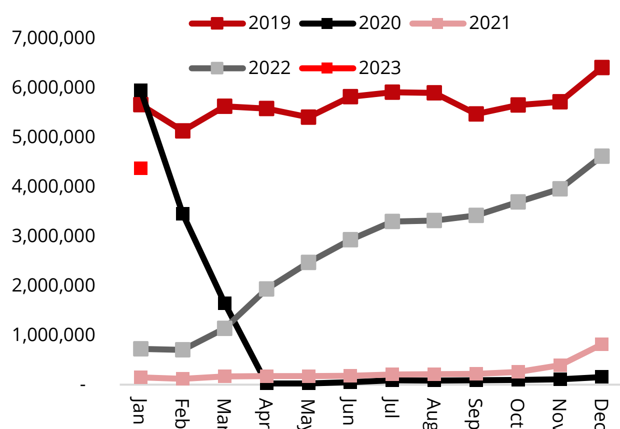
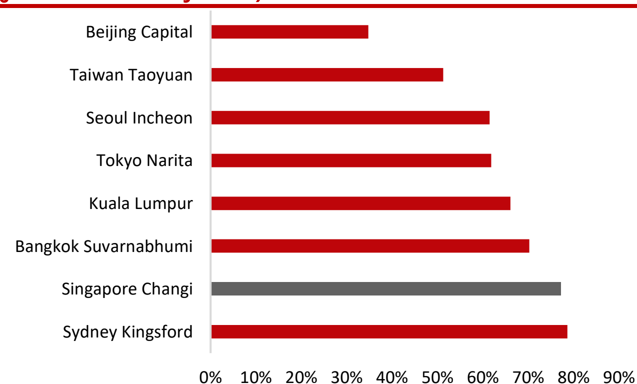
Air travel in Asia Pacific to catch up with other regions in 2023, with Singapore at the forefront. Changi Airport's passenger traffic experienced a remarkable rebound in 2022, surging to 77% of 2019's level as of Jan-23, compared to a meagre 13% in Jan-22. Although other countries in the region also saw a significant increase in passenger traffic as travel restrictions were progressively relaxed, Singapore's recovery outpaced them. Looking ahead, we anticipate air passenger traffic in Asia Pacific will continue to recover lost ground in 2023, particularly international travel, as most travel and pandemic-related restrictions in the region have been lifted. We expect Singapore to maintain its lead over other countries and see air traffic to and from the country return to normal by end-2023, thanks to its more successful efforts to restore flights to China.

Changi Airport historical passenger movements



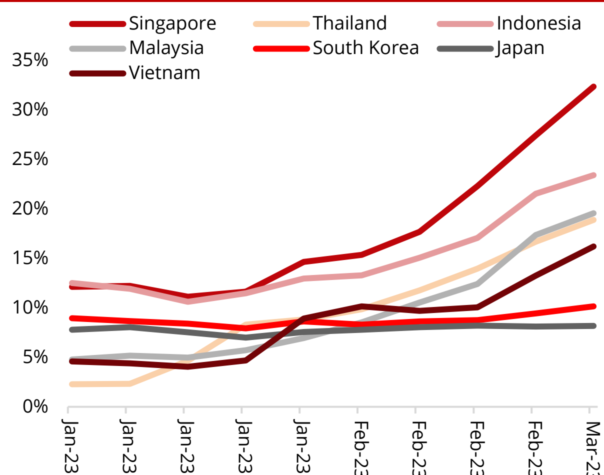
Source: CAPA., DBS Bank Ltd

Passenger traffic recovery across APAC airports (Jan-23 as a % of Jan-19)



Source: CAPA., DBS Bank Ltd

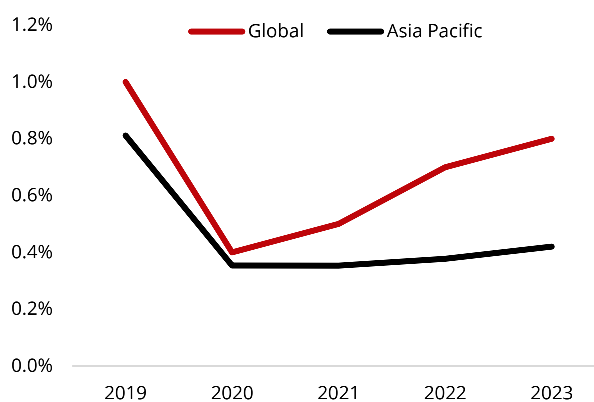
Passenger capacity to and from China (% of 2019)



Source: CAPA., DBS Bank Ltd

Understandably, macroeconomic headwinds are shrouding the outlook for air travel in the region, with stubborn inflation threatening to curtail discretionary consumer spending. However, it is important to bear in mind that the Asia Pacific region still has a considerable gap to close compared to other regions like Europe and North America, which reopened much earlier. Between 2020 and 2022, the Asia Pacific region's air travel spend as a % of GDP remained stagnant at 0.4%, a significant decline from 0.8% in 2019. In contrast, global air travel spend as a % of GDP increased from 0.4% in 2020 to 0.7% in 2022, although it is still below the pre-pandemic level of 1.0% in 2019.

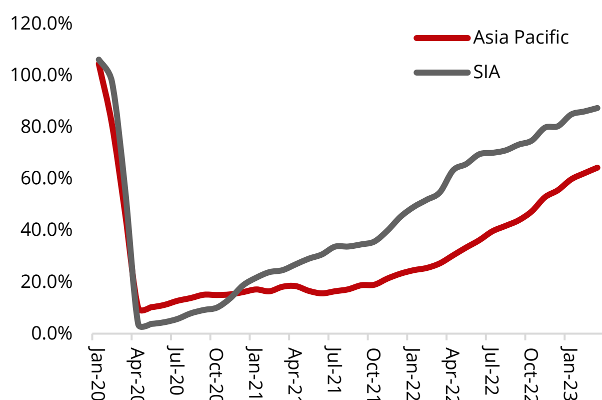
Historical air travel spend as a % of GDP



Source: IATA, IMF, DBS Bank Ltd

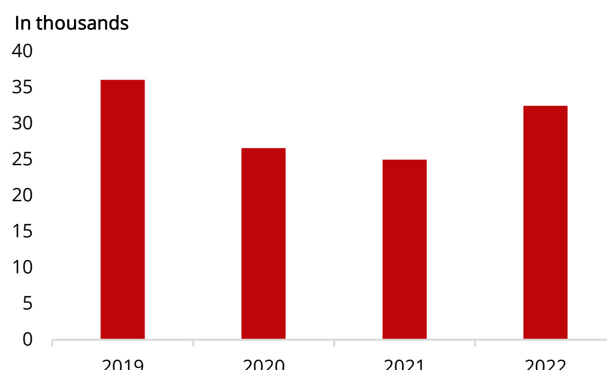
SIA's passenger traffic recovery will continue to outpace peers in the region. SIA saw a marked turnaround in passenger traffic in 2022, with group (including Scoot) passenger capacity climbing to 80% of pre-pandemic levels in Mar-23, up markedly from 38% in Jan-22. Conversely, the international capacity of competitors in the region was only at 64.3% during the same period, mainly due to their relatively higher dependence on traffic from China and greater impact from resource constraints. SIA's outperformance is expected to carry on in the near-term, given robust forward booking data and the group's considerable strides in restoring flights to China, with the group projected to reach 80-90% of its pre-COVID capacity to China by Oct-23, up from 25-30% currently. Challenges in the form of labour (particularly pilots) and aircraft shortages will continue to hinder competitors in the region from fully restoring capacity in the short run, but we believe SIA is capable of ramping up its capacity to pre-COVID levels. As a result, we expect SIA's passenger traffic to normalise by late 2023, while most peers are likely to trail by at least one to two quarters.

SIA and APAC airlines historical international passenger capacity (% of 2019)



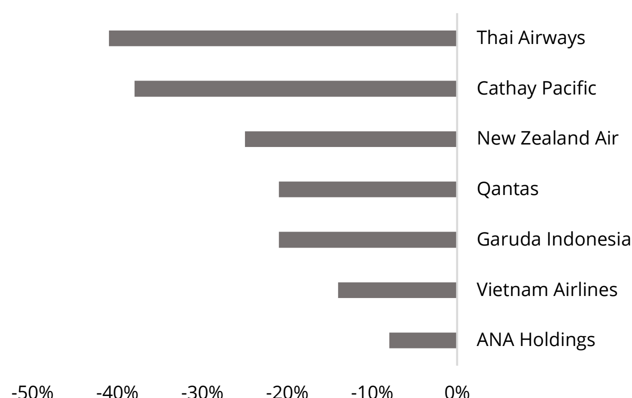
Source: Company, CAPA, DBS Bank Ltd

Singapore aviation sector employment



Source: Ministry of Manpower, DBS Bank Ltd

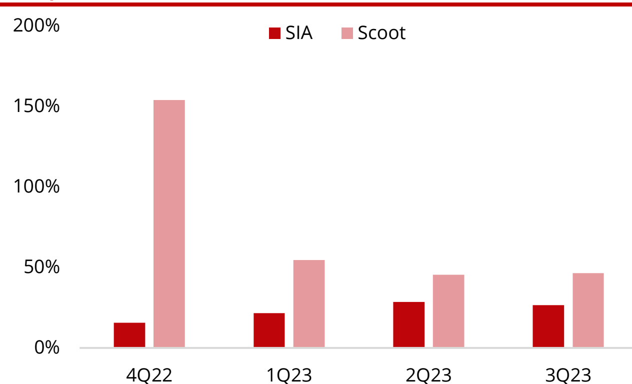
Asia Pacific airlines current manpower vs pre-pandemic level



Source: Companies, DBS Bank Ltd

Passenger yields should trend lower but will likely sustain above pre-pandemic levels. Passenger yields of airlines in the Asia Pacific region were on average 25-30% above 2019 levels in the final quarter of 2022. SIA and Scoot's passenger yields were 27% and 47% above pre-pandemic levels respectively in 3QFY23 (Oct-Dec 22), strengthening from previous quarters despite both airlines ramping up capacity and facing stiffer competition. While we expect pricing pressure as competitors continue to increase their number of flights, we believe it will take time for air fares to return to normal due to immense pent-up travel demand and the gradual addition of passenger capacity. Additionally, strong premium leisure demand, coupled with the gradual return of high-margin corporate travellers will also be supportive of passenger yields.

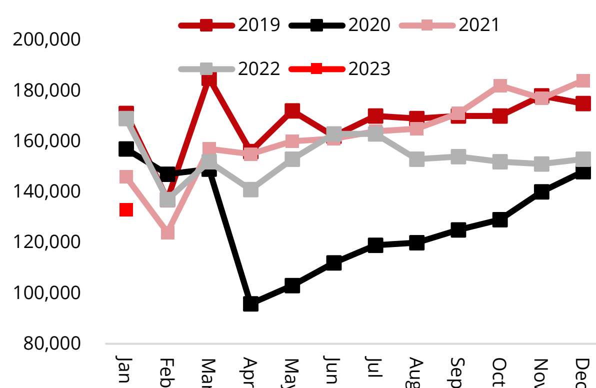
SIA and Scoot historical passenger yields (% change vs 2019)



Source: Company, CAPA, DBS Bank Ltd

Bleaker air cargo market will not adversely impact STE; strong passenger revenue growth to temper softer cargo revenue for SIA. The lackluster macroeconomic growth outlook will inevitably lead to lower manufacturing and trade activity, and consequently lower air freight volumes. Although the period from October to December tends to be a seasonally stronger, cargo throughput at Changi Airport continued to fall during the period, with a 21% y-o-y drop in volumes processed in Jan-23. Air freight rates, which have already fallen dramatically from their peaks, should also continue to trend lower due to weaker demand and increased supply with the return of more passenger aircraft. However, the weaker air cargo environment will not have an impact on STE, given that the group's passenger-to-freighter (P2F) conversion lines are already fully booked until 2026 with pricing already fixed. At the same time, while SIA will likely see an acute drop in cargo revenue going forward, we expect this to be more than offset by stronger passenger revenue.

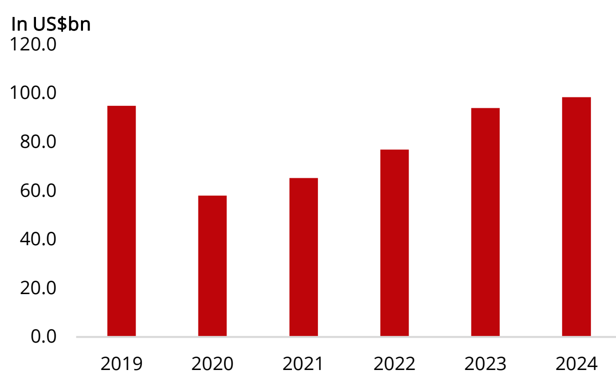
Changi airport historical airfreight movements



Source: Company, CAPA, DBS Bank Ltd

STE and SIAEC to benefit from upbeat MRO recovery outlook. MRO (Maintenance, Repair and Overhaul) activity in Asia Pacific saw a considerable rebound in 2022 but lagged the other regions due repeated lockdowns in China and the slower resumption of international air travel in the region. However, Asia Pacific could show higher growth versus the other regions in 2023. Oliver Wyman expects global MRO spending to grow by 22% in 2023 to reach US$94bn, just shy of its 2019 peak by 2%, but MRO spending in Asia Pacific (excluding China and India) is expected to surpass 2019's level due to significant deferred maintenance that cannot be postponed. Meanwhile, MRO demand in China and India is expected to expand the most rapidly over the next few years, in tandem with outsized fleet growth in the two countries.

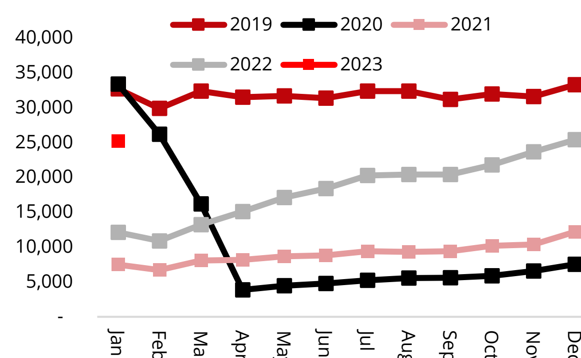
Global MRO market forecast



Source: Oliver Wyman, DBS Bank Ltd

While STE's airframe hangars were operating at near capacity over the course of 2022 because of aircraft reactivation and P2F work, the group's engine and component shops were still operating at notably lower utilisation levels, owing to a surplus green-time engine and used serviceable materials. In contrast, SIAEC's MRO operations are concentrated in Singapore and widebody aircraft, resulting in a slower recovery. In the final quarter of 2022, flights handled by STE's line maintenance unit was at 71% of pre-pandemic levels, while the number of base checks performed was similar to pre-pandemic levels but with lighter work content. However, the group's MRO business is expected to see a significant turnaround in 2023 as flight activity in Singapore and the region returns to normal.

Changi airport aircraft movements



Source: Company, CAPA, DBS Bank Ltd

The sector is relatively insulated against rising interest rates. Healthy leverage levels among SIA and SIAEC mean that higher interest rates will have minimal impact on them. SIA's adjusted net gearing (by treating MCBs as debt) was at 0.5x as of Dec-22 (down from 0.9x as of Mar-22), while SIAEC continues to sit on a substantial net cash hoard of around S$576.8m in the same period. On the other hand, STE's earnings will be negatively impacted by rising interest rates, given the substantial increase in the group's debt burden and exposure to floating interest rates (47% of total debt as of Dec-22). Tentative estimates provided by STE point to an increase in its cost of borrowing to 3.2-3.3% in FY23F, up from 2.4% in FY22. Nonetheless, STE is expected to achieve an improvement in core operating profits that will more than offset the increase in finance costs.

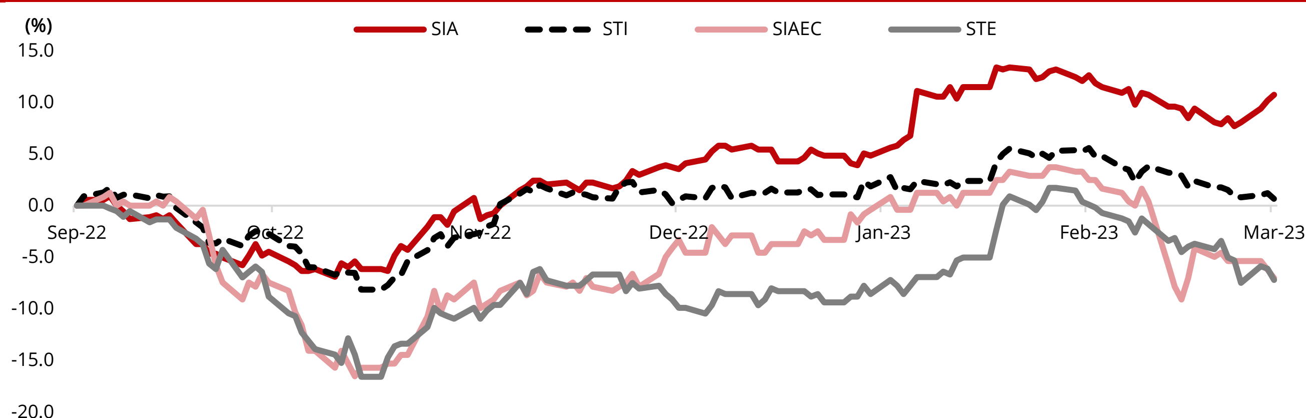
Company	Core earnings growth forecast (FY23F* y-o-y)	Key earnings drivers	Key risks
STE	12.4%	Divestment of loss-making Marine business, which incurred annual net loss of around S$80m in FY22 Full-year positive contribution from TransCore, including lower transaction and integration costs of around S$10-15m in FY23 vs S$30m in FY22 Lower energy-inflation costs as compared to FY22 (-ve impact of S$36m) with normalisation of commodity/electricity prices Continued business recovery in commercial aerospace business; defence business to remain resilient amid heightened geopolitical tensions Sustained operating margin expansion, with P2F programme turning EBIT positive, increased economies of scale, and positive cost-cutting impact Higher interest expense and absence of one-time US pension restructuring gain	Wage inflation and general inflation pressures Protracted supply chain bottlenecks
SIA	5.4%	Increase in passenger traffic, with passenger volumes normalising by 3QFY24 Passenger load factors maintaining at above pre-pandemic levels Passenger yields moderating but staying above pre-pandemic levels Steep decline in air cargo rates and load factors Lower unit costs due to fall in jet fuel prices and increased efficiency with restoration of capacity	SIA may see a sharp drop in earnings in FY25F as passenger yields return to pre-pandemic levels and the airline books a greater share of losses from Air India as an associate Uncertainty on investment quantum required to finance Air India's ambitious growth aspirations
SIAEC	67.8%	Line maintenance volumes to normalise in tandem with traffic at Changi Airport by end-2023 Base maintenance to enjoy greater work volumes as more aircraft return into service and deferred maintenance comes due Stronger contribution from JVs and associates as engine and component shops see more work with aircraft utilisation normalising and run down of green-time engine and used serviceable materials	Wage inflation and general inflation pressures Protracted supply chain bottlenecks

*- Represents FY24F for SIA and SIAEC due to their March financial year-end

Share price weakness is an opportunity to position for the reopening narrative. Apart from SIA, the performance of other aviation counters like STE and SIAEC trailed the broader market over the past six months. While SIA's share price has held firm in the past month, the share prices of STE and SIAEC corrected following disappointing earnings performance. We view the share price weakness as overdone, given that the earnings outlook on the MRO sector continues to be bright. Hence, current valuations present a good buying opportunity, in our view.

STE is our top pick in the sector, due to its strong earnings growth profile – 14% CAGR between FY22-24F – and attractive valuation at the -1.2 standard deviation (SD) level on a forward P/E basis. We also favour SIA, as we believe the street is still overly conservative on the airline's earnings prospects and valuations are still reasonable at around -0.4SD on a forward EV/EBITDA basis, though fears of a hard landing beyond FY24F and uncertainty on its required investment in Air India could weigh down the stock. While we expect SIAEC to convincingly return into the black from 1HFY24F, our optimism on the stock is somewhat moderated by its relatively higher valuation.

Singapore aerospace sector and STI returns over the past six months



Source: Refinitiv, DBS Bank Ltd

Target price and valuation summary table

	TP (S$)	Current Price (S$)	% Upside	5-year pre-COVID-19 average valuation multiple*	Standard deviation (SD)	Current valuation (no. SD)
STE	4.20	3.43	22.4%	18.9	1.3	17.3x (-1.2SD)
SIA	6.80	5.84	16.4%	4.6	1.4	4.1x (-0.4SD)
SIAEC	2.80	2.25	24.4%	20.5	2.8	22.7x (+0.8SD)

**- Refers to forward P/E for STE and SIAEC, and forward EV/EBITDA for SIA*
Source: Refinitiv, DBS Bank Ltd

DBS Bank recommendations are based on an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
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 share price catalysts within this time frame)

**Share price appreciation + dividends*

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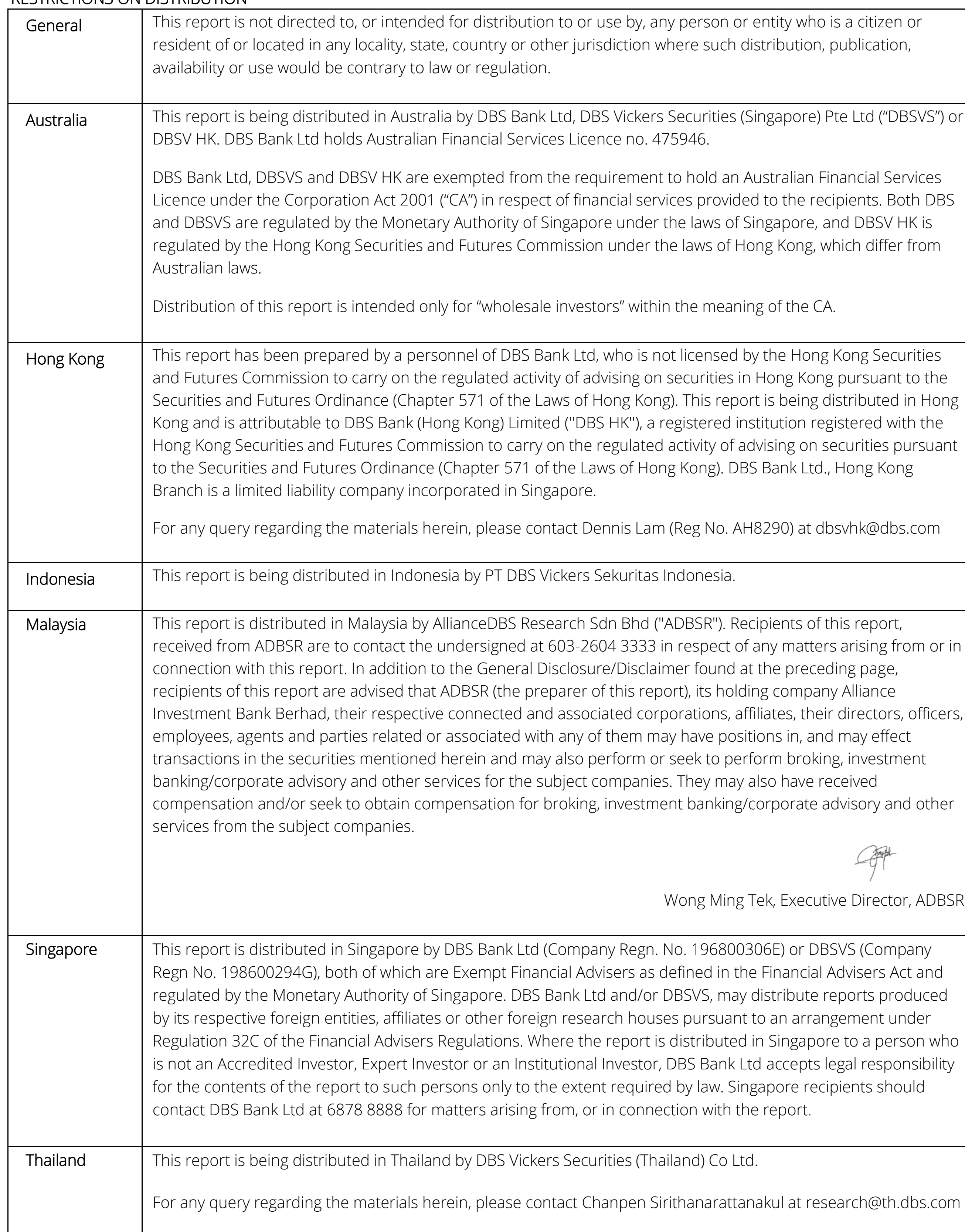

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