KGI CHINA DEVELOPMENT FINANCIAL

Keppel Corporation Ltd

(KEP SP/KPLM.SI)

Weak 2019 earnings likely priced in; attractive entry level

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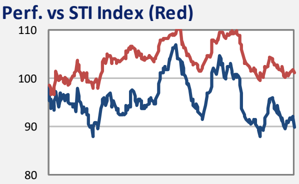
- 3Q19 PATMI declined 30% YoY to S$159mn due to the absence of divestment gains in its property segment that contributed in the prior-year period, as well as higher interest expenses.
- We upgrade KEP to OVERWEIGHT as we see value in its stock after the recent share price weakness.
- A potential upside catalyst, in our view, is the merger between KEP's O&M segment and Sembcorp Marine (SMM SP, Neutral TP S$1.59), given the removal of the overhang from Sete Brasil.

OVERWEIGHT - Upgrade

Price as of 18 Oct 19 (SGD)	5.84	**Performance (Absolute)**	
12M TP ($)	7.44	1 Month (%)	-3.9
Previous TP ($)	7.43	3 Month (%)	-10.3
Upside, inl div (%)	30.9	12 Month (%)	-9.0
Trading data		**Perf. vs STI Index (Red)**	
Mkt Cap ($mn)	10,608		
Issued Shares (mn)	1,816		
Vol - 3M Daily avg (mn)	3.7		
Val - 3M Daily avg ($mn)	22.5		
Free Float (%)	78.7%		
Major Shareholders		**Previous Recommendations**	
Temasek	20.5%	22-Jul-19	N $7.43
Blackrock	4.9%	28-Jan-19	N $7.50
Vanguard	2.2%	27-Sep-18	OW $9.43



Financials & Key Operating Statistics

YE Dec (S$ m)	2017	2018	2019F	2020F	2021F
Revenue	5963.8	5964.8	6390.6	6896.2	7401.8
PATMI	216.7	943.8	754.7	986.6	1096.5
Core PATMI	815.5	933.8	754.7	986.6	1096.5
Core EPS	44.9	51.5	41.6	54.4	60.4
Core EPS grth (%)	6.1	14.7	-19.2	30.7	11.1
Core P/E (x)	13.0	11.3	14.0	10.7	9.7
DPS (SG cents)	22.0	30.0	21.0	24.0	26.0
Div Yield (%)	3.8	5.1	3.6	4.1	4.5
Net Margin (%)	3.6	15.8	11.8	14.3	14.8
Gearing (%)	44.5	46.9	84.1	79.4	74.6
Price / Book (x)	0.9	0.9	0.9	0.9	0.8
ROE (%)	1.8	8.1	6.3	7.8	8.2

Source: Company Data, KGI Research

3Q19 summary. KEP's 3Q19 earnings missed our expectations, with cumulative 9M profits making up only 62% of our FY19 full-year earnings. 3Q19 earnings declined 30% YoY to S$153mn driven mainly by KEP's property segment. KEP's property segment net profit dropped 52% YoY to S$78m due mainly to the absence of divestment gains and higher interest expenses. The group's infrastructure segment was the only bright spot with a 56% YoY rise in net profit to S$86mn due to higher share of associate companies' profits, dilution gain from Keppel DC REIT's (KDCREIT SP, OUTPERFORM TP $2.11) private placement exercise, and higher contribution from Energy Infrastructure and Environment Infrastructure.

China property still challenged; Singapore recovering. KEP's property segment contributed to 49% of its 3Q19 profits, with sales in China and Singapore accounting for a significant portion of those earnings. Hopes for a property rebound in China may be premature as regulators seem intent to maintain a stable property market. On a positive note, Singapore's property market is showing signs of a recovery. September new home sales was the highest monthly sales since July 2018 as developers sold a total of 1,270 private residential units, an 13% MoM and 36% YoY increase.

Weak margins in O&M. Net orderbook (excluding Sete Brasil orders) declined to S$5.1bn as at end-3Q19, compared to S$5.5bn at end-2Q19. We expect its O&M operating margins to remain weak in 2019 and 2020 on the back of intense competition for projects. As such, we have not factored in a meaningful earnings contribution from its O&M segment until 2021, a view reinforced by management.

A stronger case for consolidation in Singapore's O&M sector. We believe the probability of a merger between KEP's O&M segment and Sembcorp Marine has risen following their resolution with Brazil's Sete Brasil, which has removed a significant overhang over their balance sheets. There is still significant global overcapacity in the shipbuilding industry and competition is only expected to increase as Chinese and South Korean shipyards continue to consolidate, thus creating industry heavyweights with a significantly larger footprint. The recent consolidation of China State Shipbuilding Corp and China Shipbuilding Industry Corp will create a combined entity with assets of around US$120bn, while South Korea's Hyundai Heavy Industries will have assets of about US$33bn after its planned acquisition of Daewoo Shipbuilding & Marine Engineering.

Valuation & Action: Upgrade to OVERWEIGHT. We upgrade KEP to OVERWEIGHT following the 11% decline in its share price since our last report on 22 July 2019. KEP now offers a 31% upside potential, inclusive of a 4% dividend yield. Our fair value is based on SOTP valuation of its businesses and mainly driven by property (50% of valuation), O&M (20%) and Keppel Capital (10%). These three businesses contribute 80% of our fair value estimates of the group. KEP's track record of unlocking value via divestments may provide further upside to our earnings and dividends forecasts.

Risks: KEP's property segment now contributes the largest share of profits. As a result, a slowdown in the property sector in its key markets like China and Singapore will have the largest impact on KEP's valuations.

Figure 1: SOTP Valuation

	Stake (%)	Valuation Method	Value (S$m)	Keppel's Share (S$m)	Per Share (S$)	% of total value
Offshore & Marine						
Offshore & Marine	100%	1x FY19F P/B	2,600	2,600	1.43	19%
Property						
Property	100%	0.8x FY19F P/B	7,179	7,179	3.94	53%
Infrastructure						
Keppel Infrastructure Trust	18%	Market price	2,746	500	0.27	4%
Other Infra assets (e.g., Kep T&T)	100%	10x FY19F P/E	1,300	1,300	0.71	10%
Investments						
Keppel Capital	100%	15x FY19F P/E	1,050	1,050	0.58	8%
KrisEnergy	38%	Market price	0	0	0.00	–
Dyna-Mac	25%	Market price	90	23	0.01	0.2%
Tianjin eco-city	45%	Discounted surplus	920	920	0.50	6.8%
Total Value (S$m)				**13,571**	**7.44**	
Shares (m)				1,825		
Value per share (S$m)				7.44		
Current price				5.84		
Upside/(downside)				27.3%		
Dividend yield (%)				3.60%		
Total returns (%)				30.9%		

Source: Company data, KGI Research

Valuations. Key change to our SOTP valuation was mainly with KrisEnergy, where we did not assign any value given its ongoing restructuring plan. KrisEnergy is currently under court protection from creditors' legal action until 14 November, where it is restructuring US$477mn of debt. Shares of KrisEnergy have been suspended since 14 August. The decline in KrisEnergy's value was offset by the increase in Keppel Infrastructure Trust's market capitalisation.

For Keppel Land, we maintain our valuation multiple to 0.8x P/B to better reflect the weak outlook for its property segment in China.

Our China macro analyst highlights that China's easing of monetary policy measures will likely not translate into a meaningful rebound as the government will be focused on stability rather than stimulus.

In Singapore, the government has stated that it will not take a hands-off approach to the property cycle and emphasised the government's aim to have a sustained property market, where prices move in line with fundamentals or income growth.

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Rating	Definition
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Neutral (N)	We take a neutral view on the stock. The stock is expected to perform in line with the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
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