

Industrials
Aerospace & Defence
 Equity – Hong Kong

Neutral

Target price (HKD)	92.00
Share price (HKD)	85.90
Forecast dividend yield (%)	2.6
Potential return (%)	9.7

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

Performance	1M	3M	12M
Absolute (%)	0.7	-0.2	-5.8
Relative ^A (%)	4.2	-5.9	-15.5

^AIndex Hang Seng Index

RIC	0044.HK
Bloomberg	44 HK

Market cap (USDm)	1,839
Market cap (HKDm)	14,287

Enterprise value (HKDm)	16,243
Free float (%)	25

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HAECO (44 HK)

N: TIMCO restructuring creates further recovery delays

- **Recurring profit below forecast due to unexpected losses in HAECO Americas; other businesses in line**
- **Guidance mixed, decent outlook for Hong Kong and TEXL to be offset by weakness in Americas and HAESL; we cut our net profit forecast by 25% for 2015 and 20% for 2016**
- **Remain Neutral, raise TP to HKD92 (from HKD91), as rolling forward the valuation to later period offsets lower forecasts**

2014 net profit of HKD573m, down 8% versus 2013; 8% below forecast. Excluding one-off items, recurring profit dropped 16% for the full year, coming in 7% below HSBC's forecast. The best-performing units were TEXL, whose net profit rose fourfold in 2014, to HKD166m (this GE90 engine overhaul shop is rapidly gaining scale), and HAECO HK, whose net profit rose 72% off a thin base. The HAESL (Rolls-Royce engine overhaul) contribution was down 43% due largely to the phasing out of the four-engine B747-400 by Cathay Pacific. HAECO Americas (the TIMCO acquisition) posted a loss of HKD45m, well below our forecast of an HKD11m profit. This loss was due partly to unexpected restructuring costs, although the magnitude of these was not disclosed.

Guidance for 2015 is mixed. The order book for the hangar business at HAECO HK was described as strong for 2015 and 2016, with TEXL should enjoy another strong year (though it will not benefit from a tax credit as it did in 2014). In contrast, restructuring costs for HAECO Americas will continue into 2015 and a major contract has recently been completed, and not yet replaced. In addition, engine overhaul demand at HAESL is likely to deteriorate further.

HSBC forecasts lowered. As a result of the likely continued losses at HAECO Americas and the risk for further weakness at HAESL, we lower our net profit forecast by 25% for 2015 and 20% for 2016. We expect earnings to be roughly flat on a recurring basis in 2015 and then to rebound in 2016, as we assume no further restructuring costs at HAECO Americas from 2016e.

Remain Neutral, adjust target price to HKD92 (from HKD91). We value HAECO using an average of two approaches, a one-year forward PE (17x) and a discounted economic profit-to-cash flow valuation. Based on the average of these two approaches, our new target price is HKD92 per share. We roll forward our valuation period by six-months, and this offsets the downside from our lower forecast.

Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (HKDm)				
Revenue	11,927	13,773	15,350	16,822
EBITDA	1,174	1,366	1,676	1,986
Depreciation & amortisation	-639	-700	-731	-754
Operating profit/EBIT	535	666	946	1,232
Net interest	-70	-77	-58	-25
PBT	753	872	1,188	1,545
HSBC PBT	753	872	1,188	1,545
Taxation	-94	-126	-180	-234
Net profit	573	622	860	1,139
HSBC net profit	599	622	860	1,139

Cash flow summary (HKDm)

Cash flow from operations	1,264	1,575	1,842	2,132
Capex	-4,017	-750	-400	-400
Cash flow from investment	-1,182	873	-400	-400
Dividends	-349	-373	-473	-627
Change in net debt	2,635	1,485	-575	-878
FCF equity	-3,007	412	1,039	1,328

Balance sheet summary (HKDm)

Intangible fixed assets	0	0	0	0
Tangible fixed assets	8,287	8,337	8,006	7,652
Current assets	5,351	6,084	7,334	8,732
Cash & others	2,331	2,597	3,447	4,473
Total assets	15,044	15,786	16,655	17,687
Operating liabilities	4,339	3,122	3,447	3,755
Gross debt	5,959	7,710	7,985	8,133
Net debt	3,628	5,113	4,538	3,661
Shareholders' funds	6,069	6,336	6,798	7,426
Invested capital	9,752	11,614	11,634	11,492

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	61.5	15.5	11.5	9.6
EBITDA	46.9	16.3	22.8	18.5
Operating profit	72.0	24.4	42.0	30.3
PBT	3.3	15.9	36.2	30.1
HSBC EPS	-15.6	3.9	38.2	32.5

Ratios (%)

Revenue/IC (x)	1.4	1.3	1.3	1.5
ROIC	8.4	7.6	9.2	11.4
ROE	9.8	10.0	13.1	16.0
ROA	4.8	4.8	6.2	7.6
EBITDA margin	9.8	9.9	10.9	11.8
Operating profit margin	4.5	4.8	6.2	7.3
EBITDA/net interest (x)	16.8	17.7	29.1	80.4
Net debt/equity	49.1	66.2	54.9	40.7
Net debt/EBITDA (x)	3.1	3.7	2.7	1.8
CF from operations/net debt	34.8	30.8	40.6	58.2

Per share data (HKD)

EPS reported (diluted)	3.45	3.74	5.17	6.85
HSBC EPS (diluted)	3.60	3.74	5.17	6.85
DPS	2.10	2.25	2.84	3.77
Book value	36.49	38.09	40.87	44.65

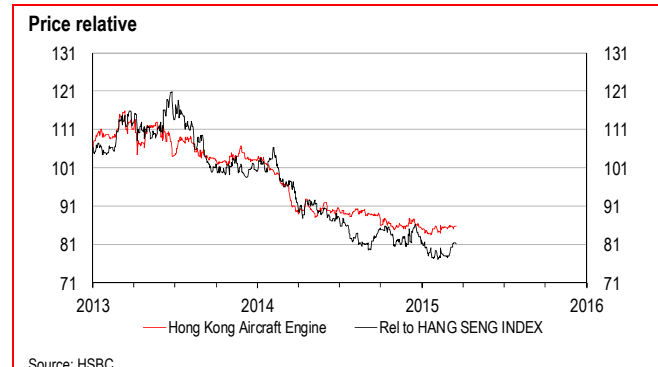
Key forecast drivers

Year to	12/2014a	12/2015e	12/2016e	12/2017e
HAECO line growth %	0	0	5	5
HAECO base growth %	-4	8	8	5
TAECO base growth %	-4	5	8	5
HAESL growth %	-30	-10	5	5
Change in rev per man hour %	63	12	4	4
Change in cost per man hour %	43	11	4	3

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.2	1.2	1.0	0.8
EV/EBITDA	9.8	9.8	7.8	6.1
EV/IC	1.7	1.5	1.3	1.2
PE*	23.9	23.0	16.6	12.5
PB	2.4	2.3	2.1	1.9
FCF yield (%)	-14.5%	4.7%	9.2%	11.3%
Dividend yield (%)	2.4	2.6	3.3	4.4

*Based on HSBC EPS (diluted)



Note: Priced at close of 17 March 2015

With this note, we introduce our 2017 forecasts

2014 result versus prior year and HSBC's forecast

HKDm	2014	2013	Change	HSBC 2014e	Diff	2H14	2H13	Change %	HSBC 2H14e	Diff %
Hong Kong	103	60	72%	75	37%	61	16	281%	33	85%
HAESL	267	465	-43%	273	-2%	131	210	-38%	137	-4%
Xiamen	89	90	-1%	92	-3%	38	28	36%	41	-7%
TEXL	166	39	326%	150	11%	98	52	89%	82	20%
Americas	-45	na	na	11	-509%	-42	0	na	14	-400%
Other	19	56	-66%	46	-59%	6	55	-89%	33	-82%
Recurring NP*	599	710	-16%	647	-7%	292	361	-19%	340	-14%

*Excludes one-off charges of HKD26m in 2014 and HKD85m in 2013

Source: Company data, HSBC estimates

As a result of the likely continued losses at HAECO Americas and the risk for further weakness at HAESL, we lower our 2015 and 2016 net profit forecasts by 25% and 20% respectively.

Changes to our forecasts

HKDm	New			Old		Changes		
	2015e	2016e	2017e	2015e	2016e	2015e	2016e	2017e
Net profit	622	860	1,139	830	1,079	-25%	-20%	na
HSBC net profit	622	860	1,139	830	1,079	-25%	-20%	na
EPS	3.74	5.17	6.85	4.99	6.48	-25%	-20%	na
DPS	2.25	2.84	3.77	2.25	2.90	0%	-2%	na

Source: HSBC estimates

Lift target price slightly to HKD92 (from HKD91); remain Neutral

Our first approach is to value HAECO using its one-year forward PE trading range. We set our fair value PE multiple at 17x, the average multiple during 2000-14. At 17x one-year forward PE (ie 2016e), our fair value would be HKD88 per share, versus HKD92 previously, as we roll forward our valuation to a later period but lower our forecast. Previously we used a target PE multiple of 16x.

Our second approach is a discounted economic profit valuation (this valuation is essentially the same as DCF but uses ROIC rather than a cash flow multiple to derive the terminal value). This model explicitly forecasts earnings until 2017; after 2017 it assumes NOPLAT rises at a 1% CAGR for the next 20 years. Our one-year forward fair value using this approach is HKD97 per share (from HKD104) – it declines due to the cut in our forecasts for 2015-17, lowering the multiple valuation we use for joint venture HAESL.

Previously we also used a third approach, equating ROIC/WACC to EV/IC to generate a valuation. Given the uncertainty of what the fair value ratio should be, we have decided to no longer use this approach.

Our target price of HKD92 per share is the average of our two approaches. Under HSBC's Equity Research model, the Neutral band for non-volatile stocks equals a local market hurdle rate (8.5% for Hong Kong), plus or minus 5ppt. Our target price implies a potential return of 10% (including 2015e dividend yield), within the Neutral band; we therefore rate the shares Neutral. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Upside risks to our rating and estimates include a faster-than-anticipated resolution of staff shortages and a stronger-than-expected gain of new work by TAECO. **Downside risks** to our view include execution risks related to the TIMCO acquisition and a more rapid phase-out of older-generation aircraft cutting demand for Rolls-Royce engine overhaul.

Disclosure appendix

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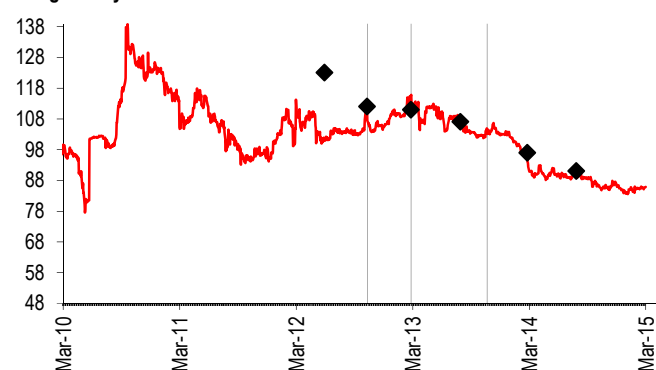
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Share price and rating changes for long-term investment opportunities

Hong Kong Aircraft Engine (0044.HK) share price performance HKD vs HSBC rating history



Source: HSBC

Recommendation & target price history

From	To	Date
Overweight	Neutral	25 October 2012
Neutral	Underweight	12 March 2013
Underweight	Neutral	4 November 2013
Target price	Value	Date
Price 1	123.00	14 June 2012
Price 2	112.00	25 October 2012
Price 3	111.00	12 March 2013
Price 4	107.00	13 August 2013
Price 5	97.00	11 March 2014
Price 6	91.00	12 August 2014

Source: HSBC

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Disclosure checklist

Company	Ticker	Recent price	Price date	Disclosure
HONG KONG AIRCRAFT ENGINE	0044.HK	85.90	17-Mar-2015	6

Source: HSBC

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