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Land Transport Sector

Unwarranted run in price post Minister's speech

SINGAPORE | TRANSPORT SERVICES | UPDATE

8 December 2015

- Market has reacted positively to a speech made by the Transport Minister.
- Run up in share price for SBST and SMRT has been unwarranted, in our view.
- We are negative on the Land Transport sector.

What is the news?

Transport Minister made a speech last Friday at a Joint Forum on Infrastructure Maintenance. He outlined the collaboration and Memorandum of Understanding (MoU) on infrastructure maintenance between LTA, PUB, SBST and SMRT during his speech. Of particular interest was the push for an integrated approach in Rail between LTA, SBST and SMRT. He also voiced his desire for LTA to establish an engineering team capable of taking on the operations and maintenance of the Rail systems, should that become necessary.

How do we view this?

Transport Minister's comments on Rail restructuring focuses on reliability through collaboration, which is vastly different from what the RFF is expected to achieve.

We view the Minister's comments positively for Rail reliability through collaboration between LTA, SBST and SMRT. We believe that the intent of the collaboration is for the three parties to work together at the upstream stages of the Rail life-cycle, to address issues as early as at the procurement and design stages. The Regulator has traditionally taken on the role of designer and builder, but had failed to take into consideration downstream issues which SBST and SMRT, as maintainer and operator have a better grasp of. We believe that the Transport Minister is firmly committed to improving the Rail reliability through identifying problems early before they subsequently cascade into bigger problems. Possible impact would be lower expenses for Repair & Maintenance in the future.

In contrast, the transition to RFF, which was first publicised by SMRT (and not LTA) during its full year FY3/14 results in April 2014, has the sustainability of the Rail fare business in mind, which is a profit-oriented motive.

Will transitioning to the RFF improve rail reliability? Not necessarily so.

The asset-model component of the RFF involves the LTA being responsible for ownership and renewal of operating assets and rolling stock. This would almost certainly improve free cash flow for the two incumbent PTOs as it would relieve them from hefty capital expenditures.

The revenue-model component of the RFF which the DTL is already operating on, consists of a Fixed Charge (fixed component) and a Revenue Share Charge (variable component). Transition to the RFF is widely expected to be beneficial for the PTOs, especially SMRT, turning its Rail business profitable. (SMRT 1H FY3/16 Rail business suffered an operating loss of S$9.3 mn.)

The presumption is that in lieu of spending cash on renewing operating assets, the incumbent PTOs would have more resources to channel to maintenance. This is debatable and it remains to be seen whether that will really happen.

Negative

LAND TRANSPORT SECTOR

	RATING	Target Price (S$)	Closing Price (S$)	Mkt. Cap. (S$ mn)
CD	Neutral	3.08	3.11	6,687
SBST	Not-rated	-	1.965	608
SMRT	Sell	1.110	1.525	2,324

Source: Bloomberg, PSR

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Sector acronyms

BPLRT	Bukit Panjang LRT
BSEP	Bus Service Enhancement Programme
BSOL	Bus Service Operating Licence
BSRF	Bus Service Reliability Framework
CCL	Circle Line
CD	ComfortDelGro Corp Ltd
CRL	Cross Region Line
DTL	Downtown Line
FRMC	Fare Review Mechanism Committee
GCM	Government Contracting Model
JRL	Jurong Region Line
LRT	Light Rapid Transit
LTA	Land Transport Authority
LTMP	Land Transport Master Plan
MOT	Ministry of Transport
MRT	Mass Rapid Transit
NEL	North-East Line
NSEWL	North-South East-West Line
PBO	Private bus operator
PTC	Public Transport Council
PTO	Public transport operator
RFF	Rail Financing Framework
SBST	SBS Transit Ltd
SMRT	SMRT Corp Ltd
SPLRT	Sengkang and Punggol LRT
TDVL	Taxi Driver's Vocational Licences
TEL	Thomson-East Coast Line

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SMRT's 1H FY3/16 Rail maintenance-related expenses (MRE) came up to S$147 mn (12% y-o-y increase, compared to 4.4% y-o-y increase in Rail revenue). In view of guidance from SMRT during its 2QFY16 results that Rail MRE would increase to 50% of Rail revenue from 41%, full year FY3/16 Rail MRE could come up to S$309.9 mn, by estimates. Despite the increase in Repair & Maintenance (R&M) expenses over the recent quarters, Rail disruptions have become more serious. SMRT was fined S$5.4 mn for the network-wide disruption on the NSEWL in July this year – a mere 1.7% of the full year estimate for MRE.

As it is, the incumbents are operating profitable Advertising and Rental segments and are reporting profits at the Group level (SBST 9M FY12/15 net profit: S$16.32 mn; SMRT 6M FY3/16 PATMI: S$45.88 mn). We opine that the Rail businesses should be viewed in totality with the Advertising and Rental businesses associated with it. (SBST 9M FY12/15 Rail profits inclusive of Advertising and Rental components came to S$7.5 mn.) In conclusion, it is already within the incumbents' means to spend on maintenance, even without a RFF in place. As such, we do not view the Minister's comments as an indication that the transition to RFF is imminent.

We believe that LTA building up its engineering capability to operate and maintain Rail lines is a negative development for the incumbents on two fronts.

1. **It eventually makes them redundant and raises the possibility that subsequent Rail lines will not be tendered out to them.**

Subsequent Rail lines in varying stages of evaluation and development include TEL, JRL and CRL. If LTA were to have the capability to operate and maintain them, it becomes possible that the lines would not be tendered out to SBTS or SMRT. Consequently, the two listed incumbents would see limited growth in Rail revenue through an increase in ridership. This comes as at a particularly bad timing as the RFF is widely expected to improve both the profitability and cash flow for the operators.

2. **PTOs will stand to lose not just Rail revenue, but the associated Advertising and Rental revenue as well; if the LTA takes back the existing lines.**

In addition to not having new Rail lines made available to them, the incumbent PTOs run the risk of LTA taking back their existing lines, should they fail to meet the operating standards set by LTA. SBST stands to lose the NEL, DTL, and SPLRT lines; while SMRT stands to lose the NSEWL, CCL and BPLRT.

In addition to losing the license to operate the lines, the incumbent PTOs would almost certainly lose access to the trains and consequently access to the Advertising space on the trains and possibly the Rental of commercial spaces in the train stations. Revenue and profits from the Advertising and Rental businesses have been the life-line for SMRT. SMRT's 1H FY3/16 Group EBIT stood at S$60.2 mn, of which Rental contributed S$41.7 mn and Advertising contributed S$12.3 mn, while Rail business sustained S$9.3 mn operating loss. As such, SMRT's Group EBIT substantially comes from its Advertising and Rental business segments. While Advertising and Rental income is also derived from bus interchanges and taxis, we believe that the bulk of it is directly attributable to its Rail network.

We hasten to add that if LTA were to acquire the Rail assets, it would not be from the point of view of a strategic investor. A strategic investor would be prepared to pay a higher price for a company as it can either derive synergies with existing operations, or cost reduction through economies of scale. In the case of LTA, we believe it would not value the operating assets at its cash generating ability, valuing the assets instead at their book value or even lower. Ultimately, LTA's motive for purchasing Rail operating assets from the incumbents would not be for economic profit.

This would be highly detrimental to the incumbents, should the RFF be already in place and assuming that they are earning good profits from the Rail business.

Investment Actions

We believe that the market has been unduly optimistic over the Transport Minister's comments. The market has not clearly differentiated between the Rail reliability motive of the restructuring the Minister has outlined and the profitability motive of a RFF restructuring. Moreover, the market has not considered the downside implications of the PTOs becoming redundant. We do not make changes to our ratings and valuations to the two PTOs, CD and SMRT under our coverage.

- CD maintained at "Neutral", target price S$3.08 unchanged.
- SMRT maintained at "Sell", target price S$1.11 unchanged.
- SBST, "Non-rated", but the run up in share price has been unwarranted, in our view.

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