Where Are the Shareholders' Yachts?
A Good Hard Look at Austal Ltd.

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Honne Capital
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Background and Business

Background and Business

- Austal is headquartered in Henderson, Western Australia
- Austal was founded in 1988 as a manufacturer of aluminum crayfishing boats
- The company soon began building high speed ferries for the Asian and European markets

Source: Australian Broadcasting Corporation. Who are you? John Rothwell.

Background and Business

- After a decade of operations in Henderson, Austal set up a shipyard in Mobile, Alabama in 1999
  - The goal was to enter the U.S. ferry market from which foreign builders were excluded by the Jones Act
- Austal later recognized an opportunity to adapt its high speed ferry designs to satisfy U.S. Navy vessel requirements

Source: Austal 2000 Annual Report

Background and Business

- Through the 2000s Austal teamed with General Dynamics to design and build the U.S. Navy's Littoral Combat Ship (LCS)
- LCS is a multi-role warship intended for destroying submarines, sea mines and fast attack boats
- In 2010 Austal won a $3.5 billion prime contract for the construction of 10 LCSs

Source: NAVSEA. http://www.navsea.navy.mil/Media/SAS2011/CAPT%20JEFF%20RIEDEL-SAS2011.pdf

Background and Business

- Austal is also prime contractor for the Joint High Speed Vessel (JHSV) under a 10-ship contract worth $1.6 billion
- The JHSV is a Navy troop transport vessel based on Austal's "Hawaii Superferry"

Source: NAVSEA. http://www.navsea.navy.mil/Media/SAS2011/CAPT%20JEFF%20RIEDEL-SAS2011.pdf

Background and Business

- Since the founding of Austal USA in 1999:
  - Austal has transitioned itself from a high-margin commercial shipbuilder with cyclical revenues to a low-margin U.S. Navy shipbuilder with more certainty in outlook
  - Revenues tripled through 2013
  - EBIT margins dropped from 8% to less than 3%
  - Free cash flow was negative in 2009, 2010, 2012 and 2013

Source: Austal Annual Reports

Background and Business

- Today Austal generates over 80% of revenue from building the U.S. Navy's LCS and JHSV, with the balance coming from traditional shipbuilding operations in Australia and the Philippines
- Backlog is A$2.5 billion, securing construction work through to 2019

Source: Austal Macquarie Australia Conference Presentation

Background and Business

Austal Military Vessels

Littoral Combat Ship
(Independence variant)

Joint High Speed Vessel

Source: Austal Website

Background and Business

Austal Non-Military Vessels

Cape Class Patrol Boat

Wind Express 27

Source: Austal Website

Background and Business

Fiscal Year Ending June 30						
A$ (000,000 omitted)	2008	2009	2010	2011	2012	2013
Operating Revenue	605.9	490.2	520.2	503.4	652.0	900.6
Growth y/y	*13.3%*	*(19.1%)*	*6.1%*	*(3.2%)*	*29.6%*	*38.1%*
Operating Income	49.2	34.8	45.4	11.0	(13.8)	12.1
Operating Margin %	*8.1%*	*7.1%*	*8.7%*	*2.2%*	*(2.1%)*	*1.3%*
Financial Income / Other	21.6	(25.1)	5.8	8.8	26.4	14.7
Pre-Tax Profit	70.8	9.8	51.2	19.8	12.6	26.7
Income Taxes	18.5	0.6	14.0	(2.1)	1.5	9.0
Net Income	52.3	9.2	37.1	21.9	11.0	35.7

Source: Austal Annual Reports

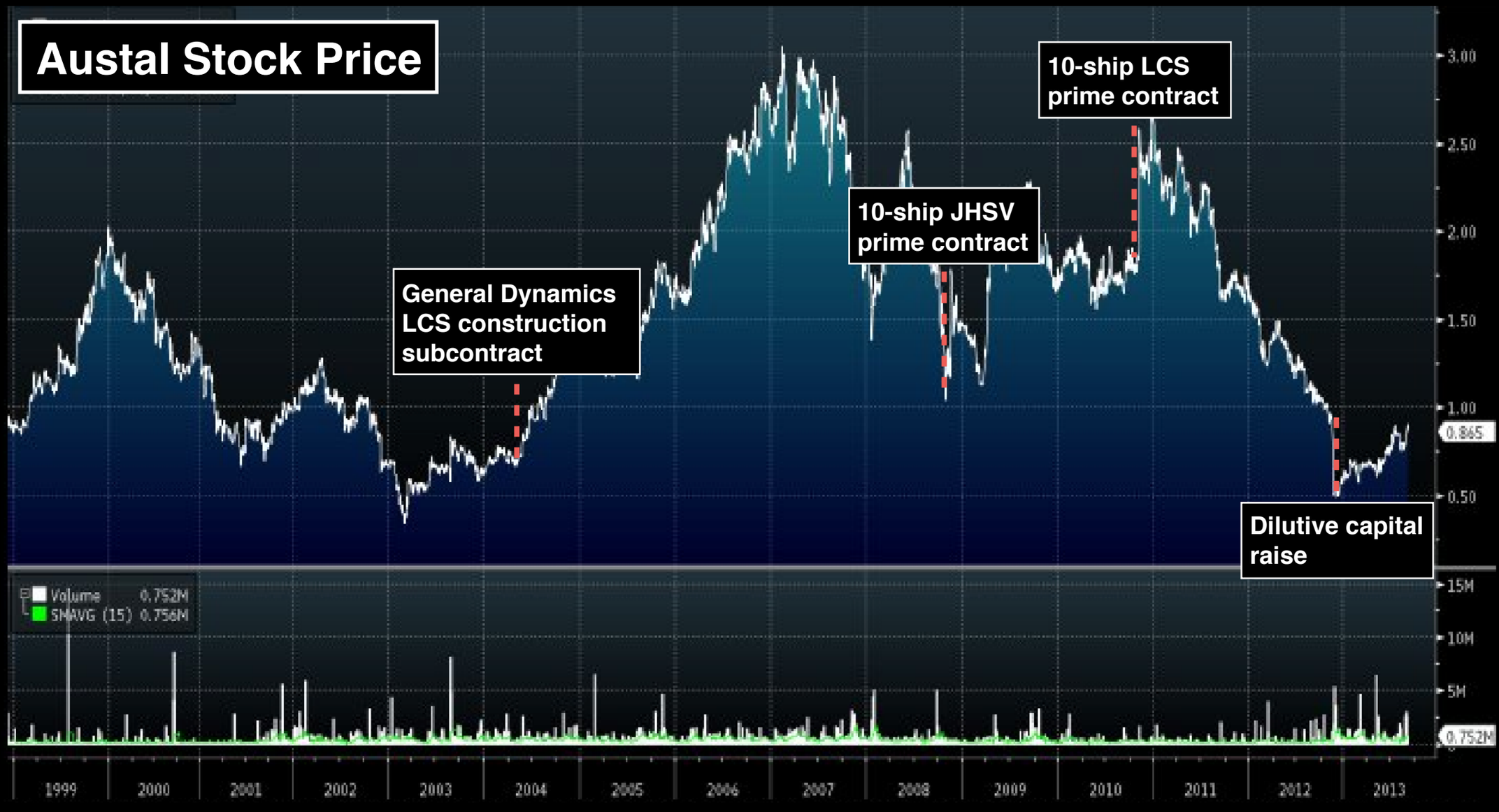
Background and Business

Market Valuation	
Stock Price	A$1.19
Shares Outstanding	346.5
Market Cap	A$412.3
Net Debt	96.6
Enterprise Value	A$508.9

Valuation Multiples		
	A$	*Multiple*
Revenue 2013	902.8	*0.6x*
Revenue 2014E	1,021.0	*0.5x*
EBIT 2013	38.1	*13.4x*
EBIT 2014E	63.5	*8.0x*
EPS 2013	0.10	*11.9x*
EPS 2014E	0.10	*11.9x*

1. Bloomberg consensus estimates and market valuation metrics as of June 6, 2014

Background and Business



Sources: Bloomberg; Austal Annual Reports

Bear Case

Bear Case

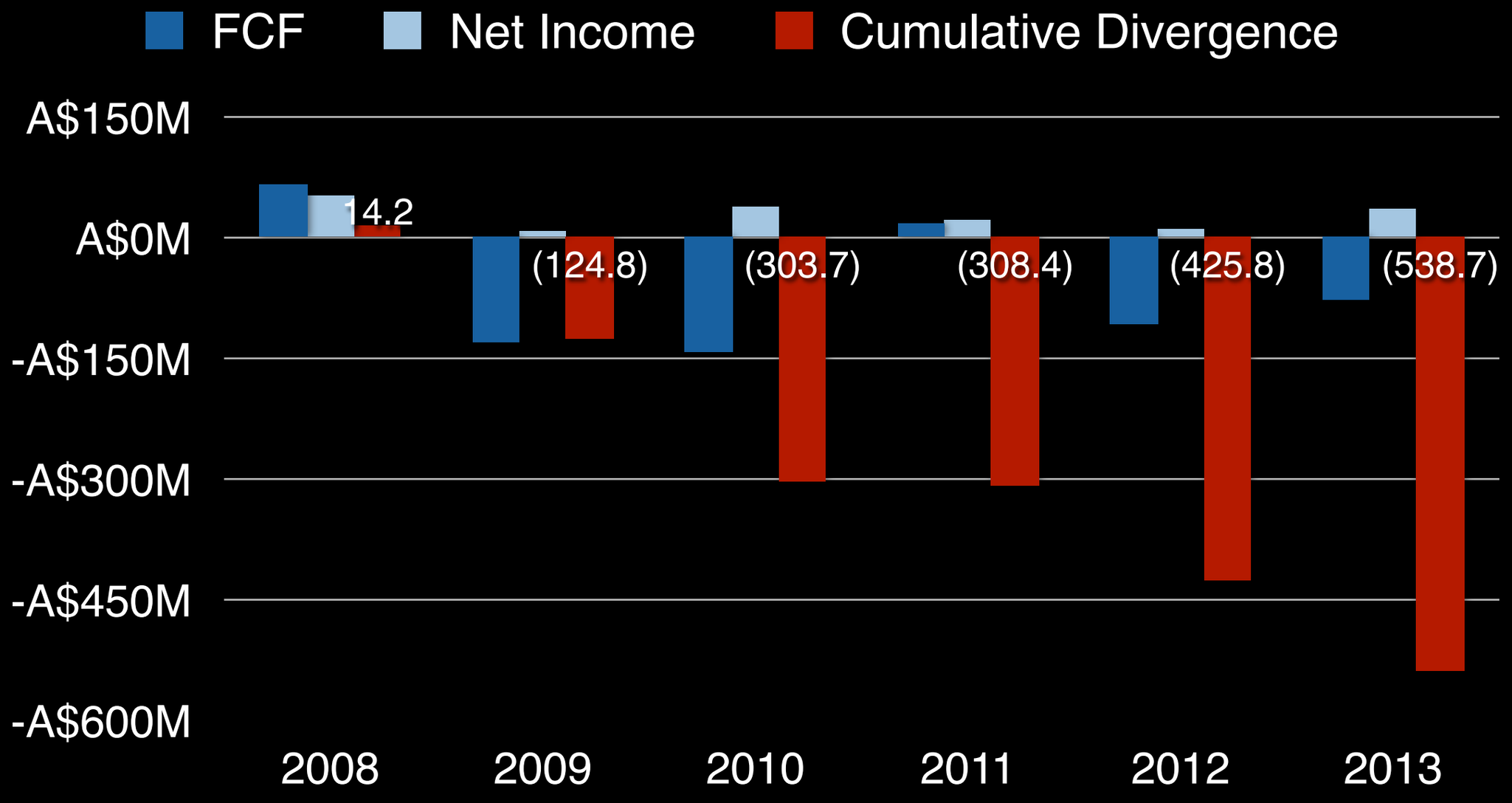
- Austal has not generated free cash flow

Fiscal Year Ending June 30						
A$ (000,000 omitted)	2008	2009	2010	2011	2012	2013
Cash Flow From Operations	87.4	(46.6)	(95.3)	62.0	33.1	(55.9)
Capital Expenditures	(20.9)	(83.2)	(46.5)	(44.8)	(131.5)	(21.3)
Acquisitions	0.0	0.0	0.0	*	(8.0)	0.0
Free Cash Flow	66.5	(129.8)	(141.8)	17.2	(106.4)	(77.2)
Cumulative Free Cash Flow	*66.5*	*(63.3)*	*(205.1)*	*(187.9)*	*(294.3)*	*(371.5)*

Source: Austal Annual Reports. *Undisclosed amount paid to acquire Australian Technology Information Pty

Bear Case

- Since 2008 Austal's reported income has exceeded free cash flow by A$538.7 million



Source: Austal Annual Reports

Bear Case

- Austal's return on capital has been poor

A$ (000,000 omitted)	2008	2009	2010	2011	2012	2013
Net Income	52.3	9.2	37.1	21.9	11.0	35.7
Net Working Capital	133.5	87.0	199.5	299.7	212.3	38.4
Acquisitions	0	0	0	*	0	0
Net Fixed Assets	106.7	187.2	217.7	208.3	370.4	399.9
CapEx	20.9	83.2	46.5	44.8	131.5	21.3
Total	261.1	357.4	463.7	552.8	714.2	459.6
Return on Capital Invested	*20.0%*	*2.6%*	*8.0%*	*4.0%*	*1.5%*	*7.8%*

Source: Austal Annual Reports. *Undisclosed amount paid to acquire Australian Technology Information Pty

Bear Case

- In February 2012 Austal disclosed a first-half operating loss of A$6.3 million, citing “low level of activity in Australian business” and “first-in-class issues with JHSV1”
- Austal breached its debt covenants and was forced to reclassify ~A$200 million of long term debt to current debt

Source: Austal 2012 Financial Results Investor Briefing Package

Bear Case

- In November 2012 Austal raised A$77.9 million in a rights offering at A$0.50 per share—less than half of the then-current market price
- Austal's outstanding share count increased 120%

Source: Austal 2012 Appendix 3B

Bear Case

- By early 2013 all but two sell side analysts had dropped coverage on Austal
- “I dropped coverage on the stock in October 2012. As you correctly point out, a lot has changed and as I no longer cover it I’m not up to speed with those changes.” — UBS analyst

Bear Case

- Austal's Bloomberg feed is full of negative headlines about its key product:
  - Littoral Ship's Fitness for Asia Questioned by Some in U.S. Navy
  - Navy Said to Seek Three Littoral Ships Instead of Four
  - Hagel Expands on Reservations About Littoral Combat Ship
  - Pentagon Questions Niche Vessels as Littoral Ship Debated

Bear Case

- In July 2013 the U.S. Government Accountability Office accused the Navy of charging into serial production of LCSs before doing thorough testing of capabilities, use and cost
- “Developmental testing of the seaframes is ongoing, and neither variant has completed shock and survivability testing, which will demonstrate that the ship designs can safely absorb and control damage.”

Source: Significant Investments in the Littoral Combat Ship Continue Amid Substantial Unknowns

The McCain Mutiny

- Senator John McCain, member of the House Armed Services Committee, piled on the criticism:
  - The LCS cannot survive a hostile combat environment
  - Cost per ship has doubled since inception
  - “Revolutionary” design is inferior to what came before it
  - System cannot demonstrate its most important warfighting functions

Source: Remarks by Senator John McCain on the Navy’s Troubled Littoral Combat Ship Program

Bear Case

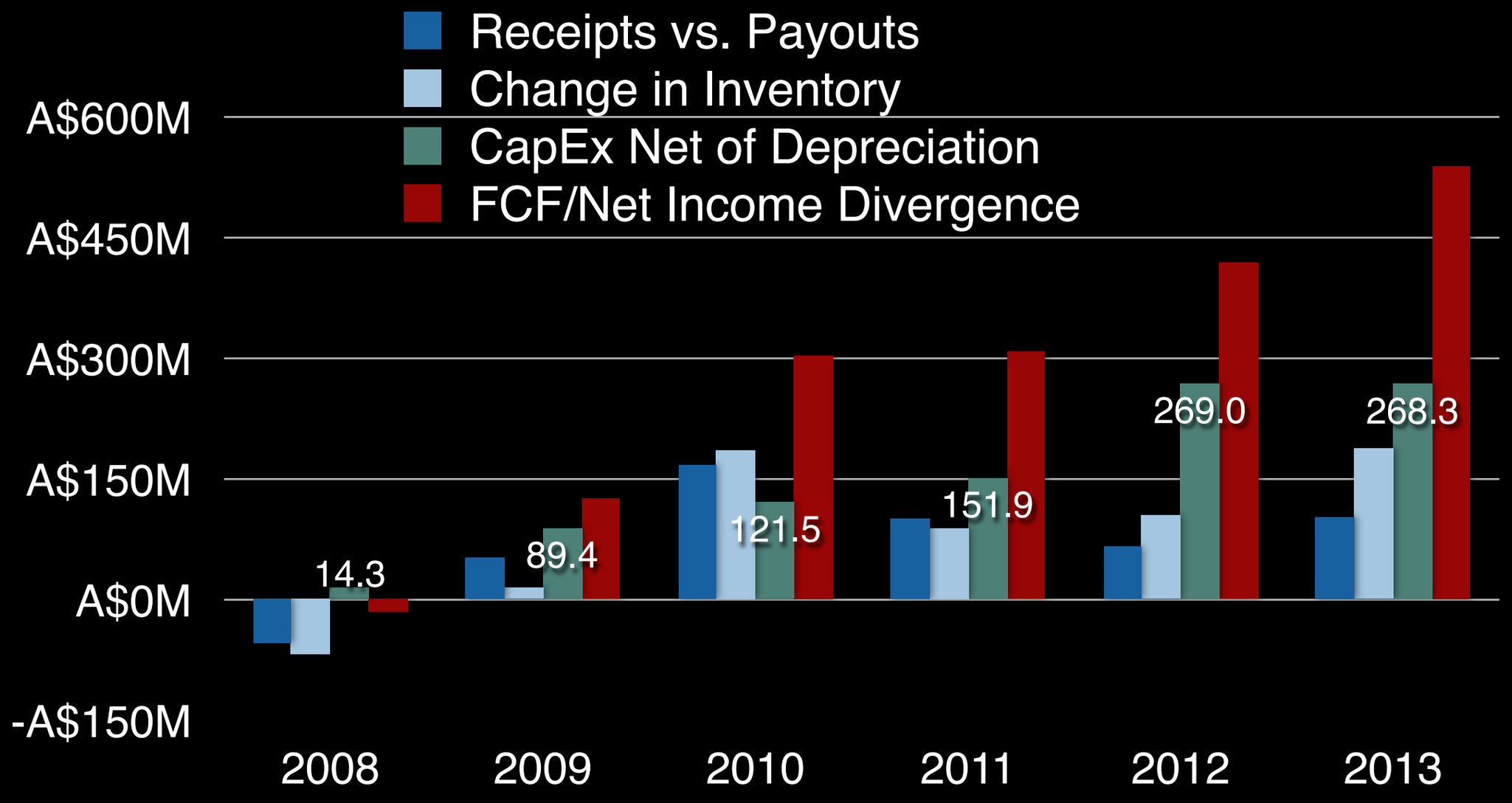
- The Navy had planned to buy an eventual total of 52 LCSs, representing one-sixth of the future 300-ship fleet
- However in February 2014 Secretary of Defense Chuck Hagel announced that “no new contract negotiations beyond 32 ships will go forward.”
- If the Navy ultimately buys 32 LCSs, Austal will have built only 16 ships versus 26 under the original plan

Source: Congressional Research Service. http://www.fas.org/sgp/crs/weapons/RL33741.pdf

Business Quality

Is Austal a Bad Business?

- Austal's cumulative FCF / Net Income divergence is primarily the result of capex and inventory buildup



Source: Austal Annual Reports

CapEx is Mostly Non-Recurring

- From 2005 to 2012 Austal made upfront, non-recurring investments in its U.S. shipyard to prepare for serial LCS production
    - Austal quadrupled the size of its existing facility by building new construction halls
- From 2009 through 2012 average capex was A$76.5 million per year

Sources: Austal FY2005 Annual Report, FY2013 Annual Report

CapEx Forecast

- Capex in 2013 was only A$21.3 million, a 72% decrease from the prior year
- “2014 capex is forecast to be at similar levels to 2013.”[1]
  - Austal’s capex in the first half of FY2014 was less than A$2.0 million[2]

1. Austal FY2013 Shareholder Presentation 2. Austal H12014 Presentation

Inventory Buildup

- Inventory buildup is another major source of Austal's negative free cash flow, consuming A$188.7 million since 2008

Fiscal Year Ending June 30						
A$ (000,000 omitted)	2008	2009	2010	2011	2012	2013
Inventory Beginning Balance	88.7	21.1	104.8	275.3	177.9	193.5
Change in Inventory	(67.6)	83.2	170.5	(97.4)	15.6	84.4
Inventory Ending Balance	21.1	104.8	275.3	177.9	193.5	277.9
Change in Inventory (Cumul.)	*(67.6)*	*15.6*	*186.1*	*88.7*	*104.3*	*188.7*

Source: Austal Annual Reports

Inventory Buildup

- Austal's "inventory" actually represents long-term accounts receivable because it is calculated as "Construction Work in Progress" (total contractual amounts due from customers) minus "Progress Payments Received and Receivable"

Fiscal Year Ending June 30			
A$ (000,000 omitted)	2011	2012	2013
Construction Work in Progress	1,307.4	1,557.3	2,503.1
Progress Payments Received	(1,129.7)	(1,363.8)	(2,225.9)
Inventory	*177.7*	*193.5*	*277.2*

Source: Austal Annual Reports

Inventory Buildup

- Austal books revenue and earnings when cost is incurred according to the percentage of completion method
- Austal invoices the customer for the cost of labor and materials associated with work in progress once the cost has been incurred

Source: Honne Capital conversations with Austal management

Navy Payment Terms

- There is a time lag between Austal incurring the cost, invoicing the customer and receiving payment from the customer
- The Navy pays Austal 30 days in arrears for cost incurred
- As Austal's revenue grew from A$500 million to A$1 billion, its arrears payment increased from A$42 million to A$84 million

Source: Honne Capital conversations with Austal management

Navy Payment Terms

- This time lag explains why Austal appears to consume cash simply by growing revenue

A$ (000,000 omitted)	2008	2009	2010	2011	2012	2013
Receipts from customers	612.9	438.0	549.7	573.6	555.6	894.0
Payments to suppliers/ employees	(558.5)	(544.6)	(664.9)	(506.8)	(521.5)	(930.1)
Net receipts	54.4	(106.6)	(115.2)	66.8	34.2	(36.1)
Cumulative net receipts	*54.4*	*(52.2)*	*(167.4)*	*(100.6)*	*(66.4)*	*(102.5)*

Source: Austal Annual Reports

Navy Payment Terms

- Furthermore, Austal does not receive cash for profit generated until after each ship has been delivered
- Cash associated with profit is phased towards the end of the construction

Source: Honne Capital conversations with Austal management

Navy Payment Terms

- The Navy also withholds approximately 2% of the cost of the ship over a warranty period up to 12 months after delivery
- 2% of each LCS is equal to ~$8 million; 2% of each JHSV is equal to $3.2 million
- Austal has not yet received all of the money associated with LCS-4 even though it was delivered in 2013

Source: Honne Capital conversations with Austal management

Inventory Buildup

- Roughly A$70 million of the cumulative inventory buildup is attributable to Austal's "stock boat"—a 102-meter commercial trimaran ferry available for sale since 2009
- Holding cost is roughly A$1 million per year

Sources: Honne Capital conversations with Austal management, Stock boat brochure

Inventory Buildup

- In October 2013 Condor Ferries revealed its intent to buy the stock boat for £50 million (A$85 million)
- In January 2014 Austal sold an Option to Purchase contract to a “European ferry operator” equivalent to 10% of the stock boat’s carrying value
- Management expects to complete the sale in H2 FY2014, reducing net debt to under A$40 million

Sources: Stock Vessel Update, Honne Capital conversations with Austal management

Balance Sheet and Liquidity

- Austal's debt is comprised mostly of Gulf Opportunity Zone Bonds—US$151.7 million outstanding at yearend 2013
- GO Zone Bonds carry a de minimis rate of interest and mature in 2041
- However in order to access the GO Zone Bonds Austal has secured a letter of credit from several banks at a cost of 4%

Sources: Honne Capital conversations with Austal management, Austal 2013 Annual Report

What Will Austal Do With Excess Cash?

- Management is focused on debt repayment as the business generates substantial cash from operations and asset sales
- Over the next few years Austal will likely reinstate its common share dividend
- Honne Capital has suggested a share buyback at current prices

Source: Honne Capital conversations with Austal management

Market Opportunity

LCS Program

- Littoral Combat Ships have been procured since FY2010 under a pair of 10-ship block buy contracts that the Navy awarded to two builders—Lockheed Martin and Austal USA
- The Navy expects to consider contract proposals for additional LCSs in early 2015 and to finalize the contract award in early 2016

Source: Navy LCS Program: Background and Issues for Congress

We’re Gonna Need a Bigger Boat

- In February 2014 Secretary of Defense Chuck Hagel announced that “no new contract negotiations beyond 32 ships will go forward.”
- The Navy is to submit “alternative proposals to procure a capable and lethal small surface combatant, generally consistent with the capabilities of a frigate.”
- Options include: a completely new design, existing ship designs, and a modified LCS

Source: Navy LCS Program: Background and Issues for Congress

We’re Gonna Need a Bigger Boat

- The most feasible option is an up-armed LCS
- “If you start looking at how do you get affordable platforms at sea, without waiting a decade to develop a new design, LCS is going to be as competitive as anything.”
  — John Hamre, Center for Strategic and International Studies
- “Hagel’s point about the LCS isn’t that it’s a bad idea. He wants to see how it can address a wider spectrum of threats. The solution is going to be to up-gun it.”
  — Loren Thompson, Lexington Institute

We’re Gonna Need a Bigger Boat

- “I have to look at cost, because we’ve got to get enough of these ships, and I have to look at whether they could be delivered to the fleet. So if you look at those two requirements together, I do not know of another design.”
  — Ray Mabus, Secretary of the Navy
- “I suspect that we will not be coming up with something completely new… we don’t have the timeframe to do that. It takes us about 15 years to come up with something completely new, from coming up with the idea to cutting steel on it.”[1]
  — Tom Copeman, Navy Vice Admiral

1. Honne Capital conversations with VADM Copeman

We’re Gonna Need a Bigger Boat

- Robert O. Work was confirmed as Deputy Secretary of Defense on May 1, 2014
- In 2013 Work authored a 64-page paper in ardent support of the LCS: “The Littoral Combat Ship: How We Got Here, and Why” http://awin.aviationweek.com/Portals/AWeek/Ares/work%20white%20paper.PDF
- While the paper was published before Hagel’s directive to consider alternative designs, it is clear that Work would prefer a modified LCS

We’re Gonna Need a Bigger Boat

- “The National Security Cutter—if we can afford it—would be a presence ship. But we simply can’t afford that type of niche capability in the Navy. And the National Security Cutter is NOT the ship. It can’t operate the mission modules of an LCS. And it would be good for sailing around, but the LCS is very good for sailing around, too. So the National Security Cutter we don’t believe is a viable option.”
— Robert O. Work, Deputy Secretary of Defense

Source: CATO Institute. Future of the U.S. Navy Surface Fleet.

We’re Gonna Need a Bigger Boat

- “There’s really no frigate on the market that we could build up. Let’s assume that you could build a good frigate for $750 million. (All of the costs that you hear from overseas… they don’t put in the robustness in a combat ship that we do.) So let’s say you might be able to build one for $750 million. It would take several years to design and several years to build. If we were told to stop the LCS vessel right now, it would be disastrous for the U.S. Navy. We don’t really see anything that’s available on the market that would be automatically better than what we’re building now.”
— Robert O. Work, Deputy Secretary of Defense

Source: CATO Institute. Future of the U.S. Navy Surface Fleet.

We’re Gonna Need a Bigger Boat

- “What you need is something to escort your combat logistics force ships. Now the LCS will have a variable depth sonar with a multi-function towed array. It will be every bit as good of an anti-submarine warfare escort as the FFG-7 ever was. If we need to add anti-air warfare capability to it, the ship has the margins to put on evolved Sea Sparrow missiles.”
— Robert O. Work, Deputy Secretary of Defense

Source: CATO Institute. Future of the U.S. Navy Surface Fleet.

JHSV Program

- The U.S. Navy is acquiring a class of 10 Joint High Speed Vessels, all of which are under contract
- “The committee notes that the Joint High Speed Vessel (JHSV) has demonstrated the ability to transport military forces, as well as humanitarian relief personnel and materiel, in a manner that is responsive, deployable, agile, versatile, and sustainable.”
— Subcommittee on Seapower and Projection Forces

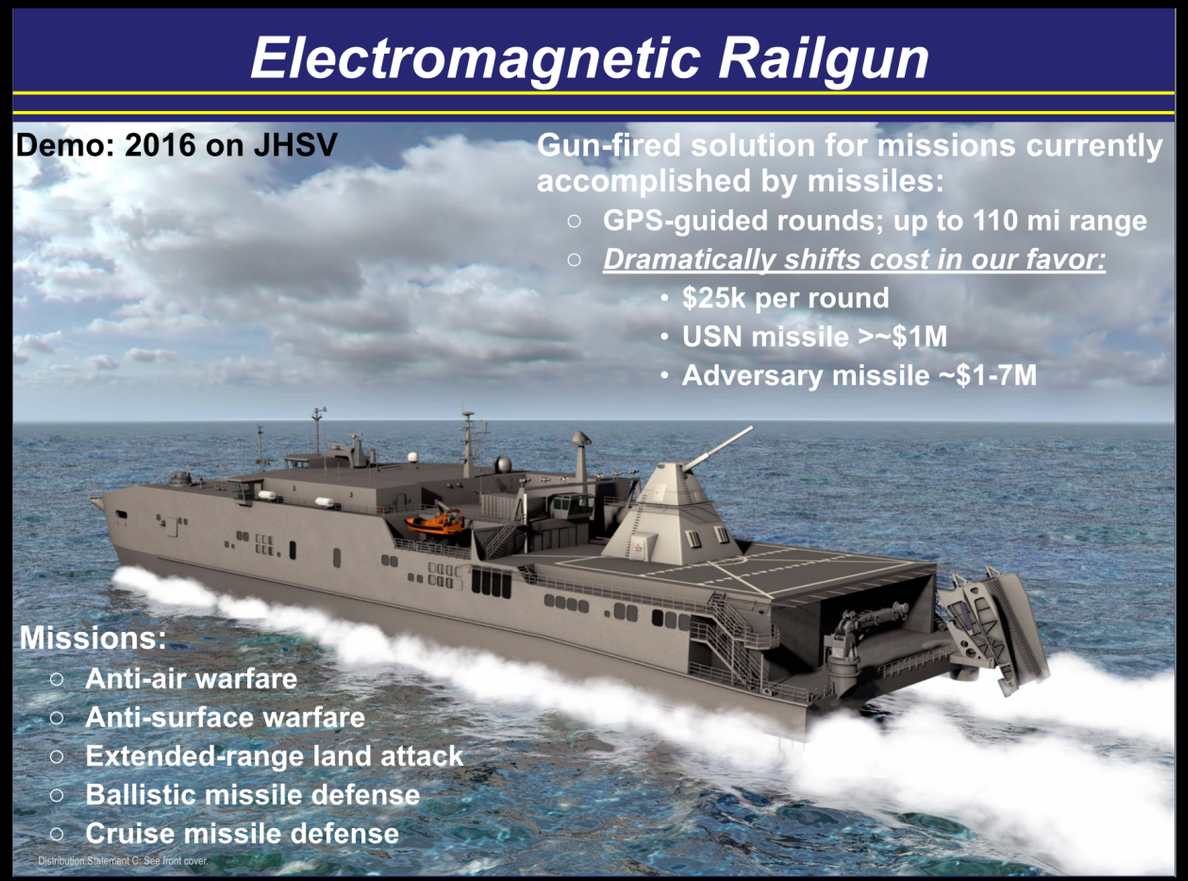
JHSV Program

- The JHSV is widely regarded as one of the Navy's most versatile ships
- "You all remember the movie Captain Phillips. They pan away. You look down there and you see the Boxer, you see the Bainbridge, you see the Halyburton. You say wow, that's very powerful! I can't afford that, you can't afford that. That was nice, but we could have done that mission with one joint high speed vessel. I'm sure of it."
— Admiral Jonathan Greenert, Chief of Naval Operations

Source: Admiral Jonathan Greenert Presentation. Sea, Air and Space Exposition 2014.

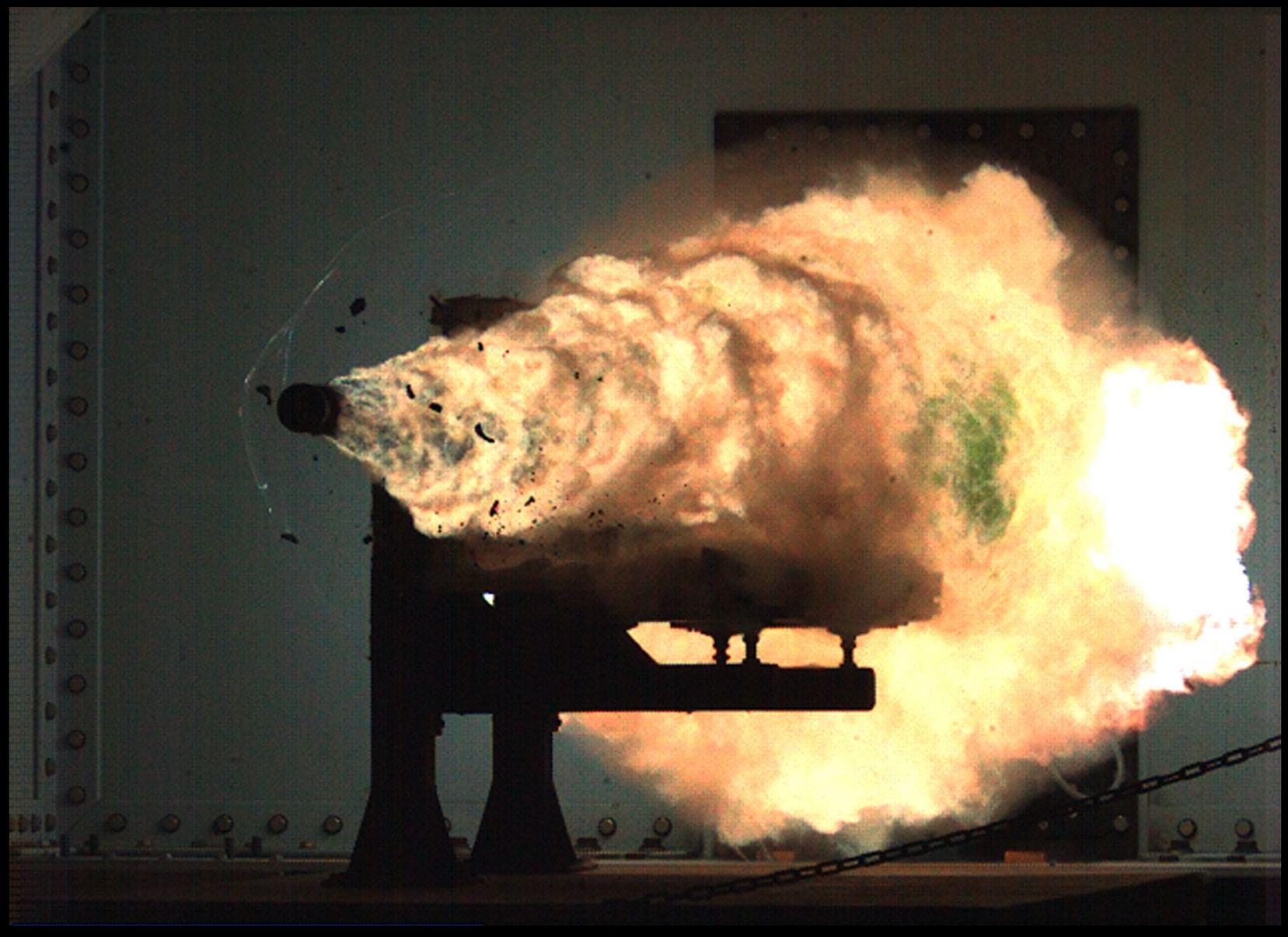
5,000 Miles Per Hour of Diplomacy

- JHSV 3—USNS Millinocket—has been selected to host the first at-sea demonstration of the Navy's electromagnetic railgun prototype in 2016



Source: Admiral Jonathan Greenert Presentation. Sea, Air and Space Exposition 2014.

5,000 Miles Per Hour of Diplomacy



Source: Admiral Jonathan Greenert Presentation. Sea, Air and Space Exposition 2014.

JHSV Program

- "JHSV is a growth item, and I would expect another block buy should LCS get sidelined."[1]
- As part of the ongoing fiscal year 2015 budget deliberations in Congress, U.S. lawmakers are requesting that the Navy provide a report on the cost and utility of acquiring eight more JHSVs[2]

1. Industry expert. 2. Subcommittee on Seapower and Projection Forces

Foreign Military Sales of HSVs

- In March 2014 Austal won a $125 million contract to design and build two High Speed Support Vessels (HSSVs) for the Royal Navy of Oman
- Austal will build the HSSVs at its Australian shipyard, without having to spend additional capex
- There is potential to grow in the Middle East region as neighboring countries recognize the utility of high speed support vessels

Source: Honne Capital conversations with Austal management

What Happens After LCS and JHSV?

- Austal USA's yards have potential long after the LCS and JHSV programs wind down
- "I firmly believe that the Navy will not allow Austal's state of the art facilities to sit idle. The Navy is quite open about how impressed they are with Austal's facilities. There is no one in the U.S. with facilities of this quality or capability."

Source: Industry expert

What Happens After LCS and JHSV?

- Austal's Module Manufacturing Facility and Assembly Halls are designed with lifting capacity and flow design to facilitate steel construction
- Current infrastructure can support steel shipbuilding with a module breakdown to fit facility capabilities and construction techniques already employed

Source: Former Austal workers

What Happens After LCS and JHSV?

- If the Navy implements a Frigate Replacement Program, the ships could be built at Austal
- Also, the winner of the U.S. Coast Guard's $10 billion Offshore Patrol Cutter contract could use Austal's facilities to build the ships

Source: Industry expert

Navy Support Contracts

Navy Support Contracts

- As the building yard for LCS and JHSV, Austal is positioned to earn a significant portion of “through-life support” revenue over the next 20-30 years
- “Winning LCS and JHSV weighed into pricing decisions on construction because we knew if we won it, then we would own the servicing franchise.”[1]
- Major support contracts for LCS and JHSV have not yet been awarded[2]

1. Former Austal workers. 2. Industry expert

Navy Support Contracts

- The Navy spends roughly 10% of the original ship purchase price each year on through-life support, which involves:
  - Maintenance (50-70% of the total): i.e. scraping barnacles off of hulls, painting, refueling, and repairs
  - Design and engineering (30-50% of the total): i.e. equipment upgrades, modifying the ship design, and adding functionality to the seaframe

Source: Industry expert

Navy Support Contracts

- The maintenance component of through-life support carries much lower margins than design and engineering
    - For example, Huntington Ingalls' service segment gross margin is just 13% (7% lower than construction segment gross margin), primarily because of the company's involvement in fleet maintenance

Source: Honne Capital conversation with Huntington Ingalls management

Navy Support Contracts

- Austal is focusing on the design and engineering component of through-life support and is teaming with a strong player in the maintenance space (i.e. General Dynamics, BAE Systems)
- Austal will cover a range of activities including sustainment, planning, design, logistics, record keep, configuration control, etc.
- This is likely to involve a team of engineers in an office with spreadsheets and design drawings

Source: Honne Capital conversation with Austal management

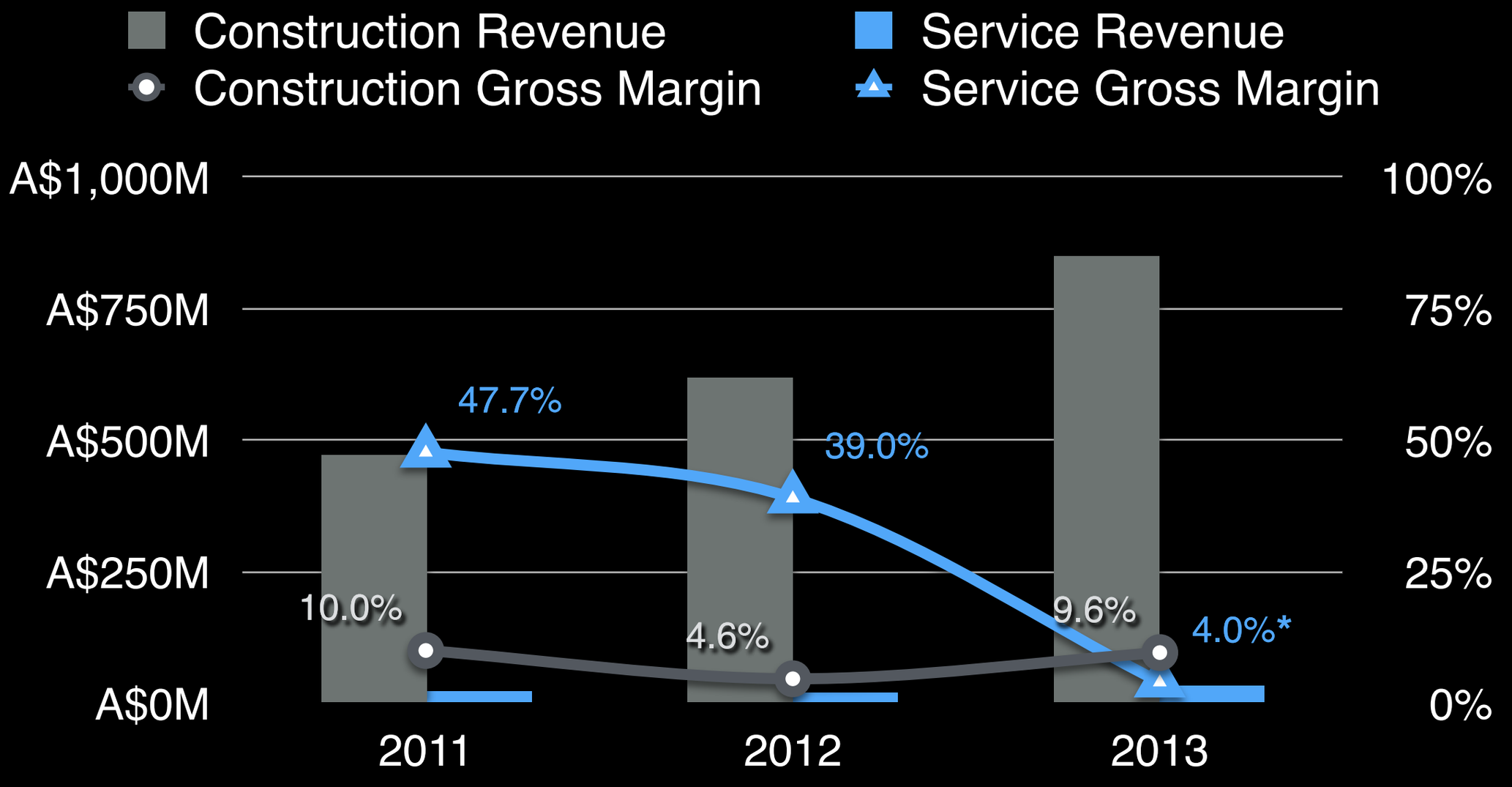
Existing Support Business

- Austal reports results from its service segment, but this only relates to the support of Australian-built vessels
- U.S. service revenue is consolidated into the construction segment and is so far immaterial
- Management intends to report U.S. Service discreetly from U.S. Construction to improve transparency once LCS and JHSV through-life support contracts ramp up

Source: Honne Capital conversations with Austal management

Commercial Support Business

- Austal's service business is relatively high-margin



*2013 not indicative of future margins due to one-time charges in service segment

Navy Support Contracts

- Naval Sea Systems Command (NAVSEA) has issued two requests for proposals for LCS through-life support: solicitation numbers N0002413R4304 and N0002413R4305

Source: Federal Business Opportunities Website

Navy Support Contracts

- N0002413R4304 covers “planning yard services”:
  - Support Planned Maintenance Management for LCS Class Ships
  - Corrective, and Continuous Maintenance Planning for LCS 2 Variants
  - Ship/Availability Product to LCS 2 Variants
  - Ship Alteration Work for LCS Class Ships
  - Emergent Installation and Repair Work onboard LCS 2 Variants

Source: Federal Business Opportunities Website

Navy Support Contracts

- "The Government intends to award the Planning Yard Services Contract between 3rd and 4th Quarter of FY2014."
  — RFP Responses to Bidders' Questions
- Note that the Government's fiscal fourth quarter ends on September 30

Source: Federal Business Opportunities Website

Navy Support Contracts

- N0002413R4305 relates to LCS sustainment:
  - Execution planning and accomplishment of planned and emergent maintenance
  - Execution planning of CNO-scheduled availabilities
  - Planning and accomplishment of facilities maintenance with emphasis on corrosion control; fly-away support; and engineering support services for LCS 1 and 2 variants

Source: Federal Business Opportunities Website

Navy Support Contracts

- The RFPs are fragmented:
  - "… must integrate work completion by multiple, likely simultaneous, organizations."
- Each contract will involve about half a dozen companies with a different scope of work

Source: Federal Business Opportunities Website

RFP: The Cubic Example

- In January 2013 Cubic Corp. won a $300 million contract to supply LCS training
- Cubic is the prime contractor; Austal is a subcontractor to Cubic
- Austal has a defined scope of work—engineering services—for Cubic to deliver the whole contract

Source: Honne Capital conversations with Austal management

Navy Support Contracts

- The Navy is still working on the deployment patterns of LCS and JHSV
- Both ship classes are intended to be forward-deployed and will be stationed overseas most of the time
- The old model of doing all sustainment work in the U.S. does not apply

Source: Honne Capital conversations with Navy Vice Admiral Tom Copeman

Navy Support Contracts

- Austal has established offices in areas that the Chief of Naval Operations has identified as important marine chokepoints: Trinidad (Panama Canal), Oman (Straits of Hormuz), Singapore (Straits of Malacca)
- Austal has self-funded operations in the geography where the U.S. Navy ships will operate
- The Navy will not have to invest in infrastructure in these locations because Austal already has the capability

Source: Honne Capital conversations with Austal management

Navy Support Contracts

- Austal has a shipyard in Australia that has built a 127-meter trimaran, same hull form as LCS
- Austal has invested in its commercial shipyard in the Philippines to act as a repair waypoint for U.S. Navy ships (700 employees)
- Expanded footprint in Darwin—team in north of Australia
- Teaming arrangement strategic partnership in Sembawang in Singapore where these ships will be deployed

Source: Honne Capital conversations with Austal management

Navy Support Contracts

- The majority of U.S.-based sustainment will be done in San Diego, CA and Mayport, FL— the homeport of the ships
- Austal does not have infrastructure there
- But as the OEM, Austal has skilled engineers in Alabama it can fly into these facilities to do a great scope of work with the teaming partner

Source: Honne Capital conversations with Austal management

Navy Support Contracts

- N00033-14-R-5300 relates to the operation and maintenance of up to five JHSVs
- Austal has bid on the design and engineering component of the RFP while leaving the operations component to someone else

Source: Honne Capital conversations with Austal management

Potential Acquirers

General Dynamics

- General Dynamics is the market leader in “planned availabilities”
- Acquiring Austal would give GD through-life support revenue for the next 30 years as the LCS and JHSV fleets are in service
- GD is intimately familiar with the Independence-class LCS; GD Advanced Information Systems is the system integrator for the ship
- If Bath Iron Works wins the Coast Guard’s Offshore Patrol Cutter contract, it could build the ships using Austal’s facilities in Mobile

Source: Industry expert

Special Security Agreement

- Austal USA is an Alabama LLC that has mitigated its foreign ownership through a Special Security Agreement (SSA) between the U.S. Government, Austal USA and Austal Ltd.
- The SSA calls for the appointment of outside directors who sit on Austal USA's board to ensure that U.S. security interests are protected
- An American-based acquirer could save roughly $1 million per year by terminating the SSA

Source: Honne Capital conversations with Austal management

BAE Systems

- BAE Systems may also be interested in acquiring Austal to secure through-life support revenue
- BAE Systems Southeast Shipyards operates adjacent to Austal USA in Mobile; an acquisition would result in significant cost savings and synergies
- If BAE were to make an offer to buy Austal, General Dynamics would be at risk of losing through-life support business as well as Advanced Integrated Systems revenue; a bidding war might ensue

Source: Industry expert

BAE Systems

- Austal already uses BAE's facilities in Mobile, Alabama for docking LCS and JHSV
- Austal and BAE do not have much overlap in business lines; acquiring Austal would be synergistic

Source: Industry expert

Putting It All Together

Putting It All Together

Austal is More Cash-Generative Than it Appears

- In the past several years Austal made substantial upfront capital expenditures to expand its facilities in Mobile, Alabama
- Capex has dropped more than 70% from 2012

Putting It All Together

Austal is More Cash-Generative Than it Appears

- Austal does not get 100% reimbursement of cost incurred plus profit until after each ship has been delivered, so cash flow lags reported income
- “Inventory” of A$277 million is actually a long-term receivable, or the amount of cash Austal expects to collect on its contracts
- This amount only includes projected payments up to LCS-16, and will grow as Austal constructs the remaining four LCSs under the 10-ship block buy

Putting It All Together

Austal's Ship Construction Segment is Improving

- Austal has gone through the learning curve with the first-in-class LCS and JHSV
- Both contracts are in serial production mode, facing less design iteration and therefore lower cost
- Sequencing at Austal's facilities has improved as the workforce matures
- EBIT margins at Austal USA have increased to 6.4% in H12014 vs. 5.5% in H12013 and 1.2% in H12012

Putting It All Together

The Navy is Likely to Order More LCSs and JHSVs

- Austal's up-armed LCS is a frontrunner for the Navy's next small surface combatant
- Robert O. Work, a long-time LCS supporter, was confirmed as Deputy Secretary of Defense on May 1, 2014
- Sell-side analysts do not incorporate any upside from contracting to build LCSs beyond Austal's current 10-ship block-buy

Putting It All Together

Austal is Expanding Foreign Military Sales

- Austal's ship designs are particularly suited to waterways in the Middle East and Western Pacific
- In March 2014 the Royal Navy of Oman ordered two Austal High Speed Vessels
- Japan has expressed interest in Austal's trimaran LCS design, and further tensions with China may help to trigger orders[1]

1. IHS Jane's Defence Weekly

Putting It All Together

Austal is Bidding on High-Margin Support Contracts

- As the prime contractor for LCS and JHSV, Austal is positioned to capture high-margin through-life support revenue, which is recurring for the entire service life of the ships (~25 years)
- Contracts are expected to be awarded by September 30, 2014

Putting It All Together

How to Assess Austal's Value

- US$250 million to be collected from the backlog recorded as of June 2013, which does not include four vessels remaining under the 10-ship block buy
- US$56 million to be collected from the stock boat sale
- For a net price of under $250 million an acquirer can own **all of Austal's intellectual property, its three state of the art shipyards and assorted land, soon-to-be-awarded servicing business, as well as further upside from more Navy orders**