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SNC-Lavalin Group Inc. (SNC C\$29.39, TSX)

No negative surprises—investors breathe a sigh of relief; maintaining Buy rating and reducing target to C\$43.50 from C\$45.25

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SNC-Lavalin Group Inc.

Rating	Buy—Average Risk
Target	C\$43.50
Symbol	SNC
Exchange	TSX
Sector	Engineering & Construction
Closing price	C\$29.39
Potential return	48%
52-week range	C\$26.00–61.95
Shares O/S	152.8m
Market cap	C\$4,490.8m
TSX weighting	0.579%
Year-end	Dec-31
Revenue	2008A C\$7,107m
	2009E C\$7,325m
	2010E C\$7,550m
EPS*	2008A C\$1.81
	2009E C\$1.99
	2010E C\$2.13
P/E*	2008A 8.6x
	2009E 7.9x
	2010E 7.3x

* Excluding ICI
 Source: Desjardins Securities

Company description

SNC-Lavalin is one of the leading engineering and construction groups in the world, and a major player in the ownership of infrastructure and in the provision of operations and maintenance services. SNC-Lavalin companies provide engineering, procurement, construction, project management and project financing services to a variety of industry sectors, including agri-food, pharmaceuticals and biotechnology, chemicals and petroleum, environment, heavy construction, mass transit, mining and metallurgy, power and water management. Founded in 1911, SNC-Lavalin has been active internationally for 50 years, establishing a multicultural network that spans every continent. The SNC-Lavalin companies have offices across Canada and in over 35 other countries around the world, and are currently working in some 100 countries.

www.sncdavalin.com



The Desjardins Takeaway

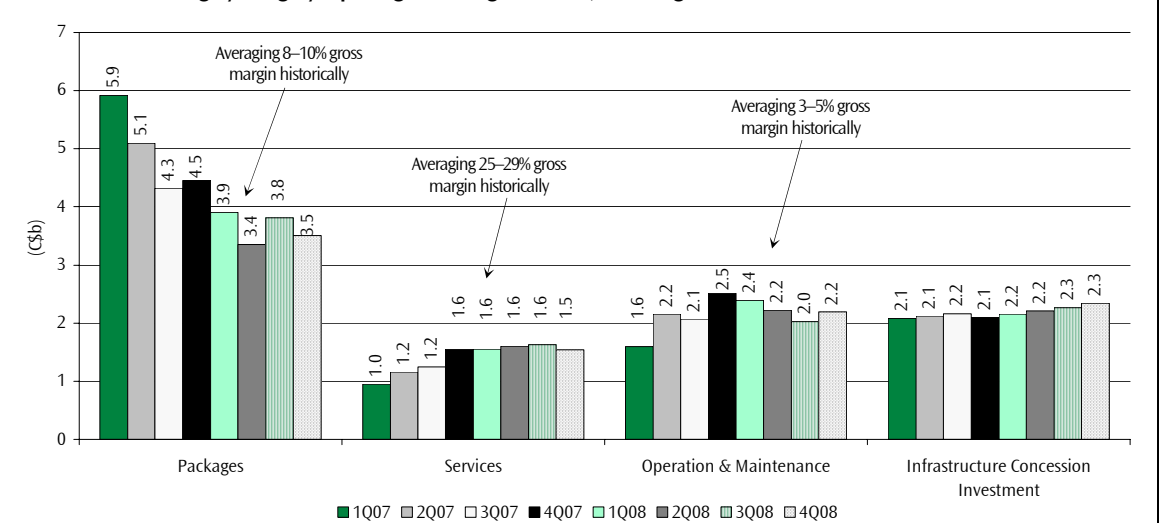
SNC reported 4Q08 results that were below our expectations. Despite the shortfall, the market reaction was positive given there were no negative surprises and several positive announcements. Backlog was stable and EPS growth expectations for 2009 were maintained. SNC also announced a 25% increase in its dividend and the retirement of its CEO. The company remains cautious about uncertainties related to the economic environment. We have reduced our earnings estimates for 2009 and 2010 to match the company's growth guidance. We rate SNC Buy—Average Risk with a revised target of C\$43.50 (down from C\$45.25).

Event

SNC-Lavalin reported 4Q08 EPS of C\$0.40 (excluding ICI, headline EPS of C\$0.49)—below consensus of C\$0.51 (note that some Street estimates may include ICI) and our expectation of C\$0.50 (excluding ICI). The main variance vs our estimate came from the shortfall in the Chemicals & Petroleum division.

Backlog stable. As of quarter-end, total backlog was down 1.5% to C\$9.6b from C\$9.7b at September 30. Both the Packages (-8.0%) and Services (-5.2%) backlogs declined, offset by an increase in Operations & Maintenance (+8.3%) and ICI (+3.4%) (see Exhibit 1).

Exhibit 1: SNC backlog by category—packages backlog has fallen; other segments are stable

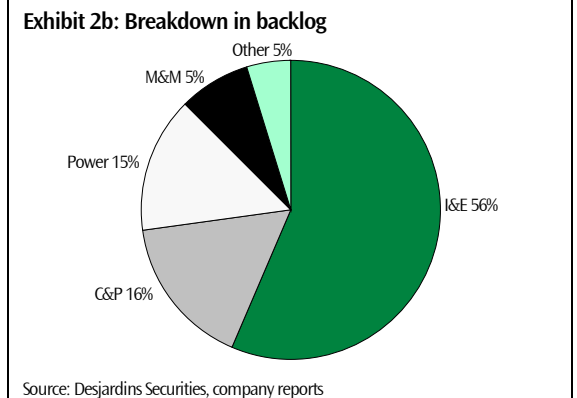


Source: Desjardins Securities, company reports

For the year, backlog improved 13.5% in the Infrastructure & Environment segment, mainly due to a 44% increase in Services backlog. This segment accounts for 56% of the E&C backlog (see Exhibits 2a–b). While backlog declined >30% in both the Chemicals & Petroleum and Mining & Metallurgy segments, management indicated that there remains a strong pipeline of work in these areas, and it does not expect revenue from these segments to decline to the same degree. We note that the company includes in backlog only contracts with a firm start date; during the quarter, it removed several projects that were delayed or cancelled, although none of these were material.

	Services		Packages		Total	
	C\$m	Yoy (%)	C\$m	Yoy (%)	C\$m	Yoy (%)
I&E	676.8	43.9	2,174.4	6.5	2,851.2	13.5
C&P	179.5	-23.8	647.9	-36.2	827.4	-33.9
Power	194.7	-19.8	546.0	-52.8	740.7	-47.1
M&M	392.0	-23.6	0.0	-100.0	392.0	-39.1
Other	102.3	8.1	139.7	24.2	242.0	16.9
Total	1,545.3	-0.7	3,508.0	-21.3	5,053.3	-16.0

Source: Desjardins Securities, company reports



4Q revenue and operating income by segment. Revenue in five out of seven segments increased during the quarter (see Exhibit 3a). Mining & Metallurgy was particularly strong, with year-over-year revenue growth of 57.5%. Chemicals & Petroleum and Power posted revenue declines of 10.3% and 38.4%, respectively. The Goreway project continued to have a negative impact on the Power segment. Goreway should begin commercial production at the end of 1Q09/beginning of 2Q09 (it is undergoing tests at this time). Canada accounted for 51% of overall revenue (38% for Packages & Services) compared with 57% (47%) in 2007. Diversification of operations outside Canada has helped to reduce the risk tied to a slowdown in construction activity in the country.

Operating income increased year-over-year in four (ICI, Other, Mining & Metallurgy, Infrastructure & Environment) out of seven segments, while losses from the Power division eased (see Exhibit 3b). Overall, strength in ICI and other segments offset losses in Chemicals & Petroleum and Power. Losses in Chemicals & Petroleum were tied to revised cost forecasts associated with a major contract. Management notes that this situation is one-time in nature.

Year-end Dec-31 (C\$m)	4Q08	4Q07	Yoy (%)	% of total
Mining & Metallurgy	244.6	155.3	57.5	12.6
Other	106.4	86.4	23.1	5.5
Operations & Maintenance	369.6	320.9	15.2	19.0
ICI	83.9	76.2	10.1	4.3
Infrastructure & Environment	503.3	498.9	0.9	25.9
Chemicals & Petroleum	351.1	391.2	-10.3	18.1
Power	285.1	462.4	-38.4	14.7
Total	1,943.9	1,991.4	-2.4	100.0

Source: Desjardins Securities, company reports

Year-end Dec-31 (C\$m)	4Q08	4Q07	Yoy (%)	% of total
ICI	13.6	6.1	122.0	14.0
Other	16.4	8.1	102.4	16.9
Mining & Metallurgy	42.1	24.1	74.2	43.4
Infrastructure & Environment	44.2	41.9	5.6	45.6
Operations & Maintenance	14.9	17.4	-14.6	15.4
Chemicals & Petroleum	-10.2	46.8	NM	-10.6
Power	-24.0	-52.6	NM	-24.7
Total	96.9	91.8	5.5	100.0

Source: Desjardins Securities, company reports

Margins down slightly from 3Q levels. Margins declined 205bps to 5%, from 7% in 3Q08. Four out of seven segments earned lower margins during the quarter (see Exhibit 4). Management indicated on the conference call that it has not seen a major change in pricing, and reiterated that the company has a disciplined approach to bidding on contracts.

Exhibit 4: Operating margins

(%)	Infrastructure & Environment	Power	Chemicals & Petroleum	Mining & Metallurgy	Operations & Maintenance	Infrastructure Concession Invt	Total
1Q06	6.9	-0.5	7.1	12.2	1.8	-14.4	4.0
2Q06	6.6	-5.8	13.1	9.3	-0.2	10.0	4.7
3Q06	4.2	-1.6	9.8	14.1	2.9	15.6	4.3
4Q06	4.1	0.4	4.9	12.5	4.9	9.2	3.9
1Q07	1.3	-128.1	7.0	13.4	2.2	3.6	-10.8
2Q07	6.3	-7.4	12.6	14.3	0.3	8.0	3.6
3Q07	4.4	-0.1	6.9	16.4	2.1	17.7	4.6
4Q07	8.4	-11.4	12.0	15.5	5.4	8.0	4.6
1Q08	0.2	7.7	11.2	6.7	3.0	0.5	5.7
2Q08	8.9	-4.9	14.3	11.0	-1.6	4.4	6.1
3Q08	7.3	-1.9	6.8	19.5	1.6	20.1	7.0
4Q08	8.8	-8.4	-2.9	17.2	4.0	16.2	5.0
Qoq chg (bps)	152	-652	-975	-233	247	-384	-205
Yoy chg (bps)	39	296	-1,487	166	-140	818	37

Source: Desjardins Securities, company reports

Annual dividend increased by 25% to C\$0.60/share. SNC announced that it will increase its quarterly dividend to C\$0.15/share from C\$0.12/share. The decision demonstrates the board's confidence in SNC's business going into 2009. We note that the company has increased its dividend by 23–33% in each of the previous four years (23% in 2004, 31% in 2005, 29% in 2006 and 33% in 2007). The new dividend represents a yield of ~2% based on Friday's closing price of C\$29.39.

Change in CEO. The company also announced that current president and CEO Jacques Lamarre will step down. Mr Lamarre has held this position for 13 years. Succeeding Mr Lamarre is Pierre Duhaime, currently EVP Mining, Metallurgy & Industrial. Mr Duhaime will take over the position on May 7, 2009. Since Mr Duhaime has been part of SNC's top management team for many years, we expect a smooth transition.

Outlook and financial objectives. The company's outlook for 2009 is cautious, given the current economic climate. Despite this, SNC maintained its financial objective to grow net income by 7–12% in 2009. Management indicated that the company's solid financial position, strong backlog, diversification by segment and geography should help it to meet this goal. Exhibit 5 illustrates the company's past annual guidance and indicates whether the results were in line, above or below expectations. We have also included management expectations for growth in operating income of each segment in 2009. We note that management has been accurate ~75% of the time in the period under review.

Exhibit 5: Management scorecard (actual operating income vs guidance)

Segments	2002	2003	2004	2005	2006	2007	2008	2009 guidance
Infrastructure & Environment	Dark Green	Dark Green	Dark Green	Dark Green	Dark Green	Dark Green	Light Green	Up
Power	Light Green	Light Green	Dark Green	Light Green	Dark Green	Dark Green	Dark Green	Up
Chemicals & Petroleum	Dark Green	Dark Green	Dark Green	Dark Green	Dark Green	Dark Green	Dark Green	Down
Mining & Metallurgy	Light Green	Dark Green	Dark Green	Light Green	Dark Green	Dark Green	Dark Green	Down
Operations & Maintenance	Dark Green	Light Green	Light Green	Dark Green	Light Green	Light Green	Dark Green	Up
Infrastructure Concession Investments	Light Green	Dark Green	Dark Green	Light Green	Dark Green	Dark Green	Light Green	Up
Others	Light Green	Light Green	Dark Green	Light Green	Dark Green	Light Green	Light Green	Flat
Total	NA	NA	NA	Dark Green	Dark Green	Dark Green	Light Green	Up

Legend: Red—below guidance, dark green—in line with guidance, light green—above guidance

Source: Desjardins Securities, company reports

Exhibit 6: Operating income

Year-end Dec-31 (C\$m)	2007	2008	2009E	2010E
Infrastructure & Environment	93	113	131	131
Power	-267	-24	65	96
Chemicals & Petroleum	126	104	90	85
Mining & Metallurgy	68	117	82	78
Operations & Maintenance	30	25	32	37
Infrastructure Concession Investments	25	37	47	49
Others	19	47	42	46
Total	94	419	489	522

Source: Desjardins Securities, company reports

Implication and recommendation

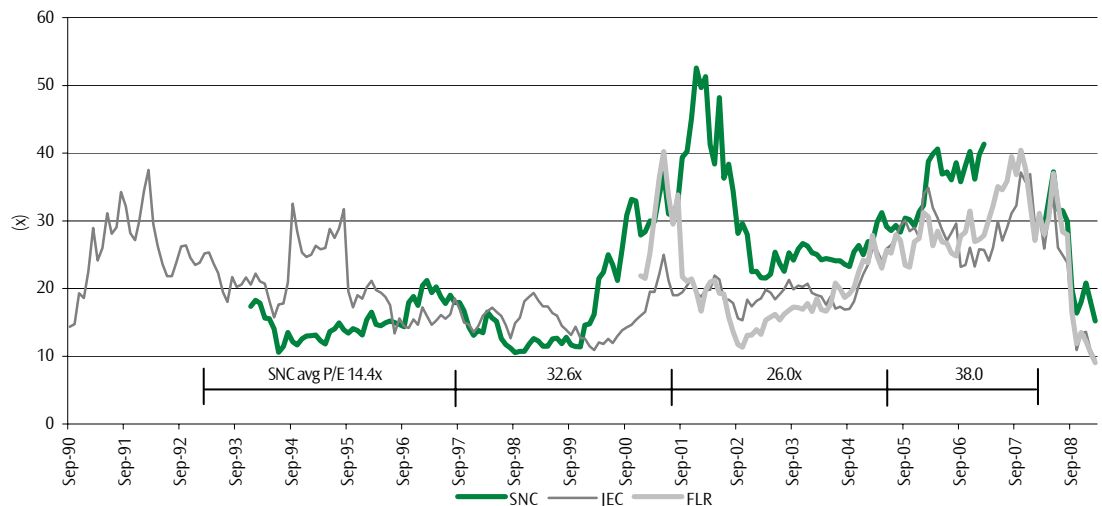
Adjustment to forecasts. Given the lower-than-anticipated EPS in 2008 for E&C activities (C\$1.81 vs C\$1.90), we are reducing our 2009 estimates to match the company's 7–12% guidance, which implies EPS of C\$1.94–2.03. We are therefore revising our previous 2009 E&C EPS forecast of C\$2.08 to C\$1.99, implying 10% EPS growth in 2009. We are also revising our 2010 EPS forecast to C\$2.13 (down from C\$2.29), implying a 7% yoy increase.

Valuation—target reduced to C\$43.50. We are not changing our 15x target multiple on our 2009 EPS estimate for the E&C business. One could argue that a 15x multiple appears aggressive given the current context; however, we highlight that we base our rationale on SNC's strong attributes: wide diversification by geography and sector, significant exposure to infrastructure spending, a cash-rich balance sheet (freehold cash of C\$600m or ~C\$4/share) and a large portfolio of opportunities. Moreover, we note that a 15x multiple represents the top of the valuation range during the 1990s. Assuming a range of 8–15x, the stock is now trading at the low end of this range—a level we view as a very attractive entry point. We continue to assume a value of C\$13.75 for the company's ICI portfolio. By combining a value of C\$29.85 for the E&C business (15x C\$1.99) with C\$13.75 for the ICI business, we derive a (rounded) value of C\$43.50 for SNC.

Exhibit 7: Summary of average monthly P/E for SNC, Jacobs and Fluor

(x)	Average					Current	Minimum
	1994–99	2000–02	2003–05	2006–07	1990–current		
SNC	14.4	32.6	26.0	38.0	23.3	15.8	10.5
JEC	18.5	17.3	21.7	29.2	20.7*	9.2	9.2
FLR	NA	22.1	20.3	31.0	24.2*	11.9	8.5

 * SNC from December 1993, FLR since December 2000
 Source: Bloomberg

Exhibit 8: Monthly P/E of SNC, Jacobs Engineering (JEC) and Fluor (FLR)


Source: Desjardins Securities, Bloomberg

Downside relatively limited even with more pessimistic assumptions. We recently published an overview of SNC's ICI portfolio and concluded that its fair valuation in the current context was ~C\$13.75/share, or ~C\$9.50 using very conservative assumptions. Since management has reiterated its 7–12% growth guidance for the E&C business and given the good visibility provided by the backlog, we believe the company is on track to achieve our 2009 base case (EPS of C\$1.99). If EPS comes under pressure, we believe our 2010 forecast would be more at risk, especially if commodity prices remain under pressure for longer than expected. However, in such a scenario, given the length of the downturn, we believe the market will begin to anticipate a recovery in 2011–12 and award a higher multiple on lower 2010 EPS (ie we believe the stock could sustain a multiple of 15x on EPS of C\$1.60). Alternatively, if our conservative case of a weaker 2010 sets in, the next-12-month P/E multiple is likely to remain under pressure (around 8–12x). Using these parameters and assuming a constant value of C\$13.75 for the ICI segment, we could see downside to C\$26–29, which is where the stock has been trading recently. Using an even more conservative assumption for ICI (our worst case of C\$9.50), downside would be to C\$22–25. We believe the recent lows reached by the stock already reflect a very pessimistic outlook.

Exhibit 9a: Target price based on various EPS and P/E multiples, using C\$13.75 for ICI portfolio

(C\$)	P/E (x)	P/E (x)				
		16	14	12	10	8
		EPS (E&C)				
1.60		39.35	36.15	32.95	29.75	26.55
1.70		40.95	37.55	34.15	30.75	27.35
1.80		42.55	38.95	35.35	31.75	28.15
1.90		44.15	40.35	36.55	32.75	28.95

Source: Desjardins Securities

Exhibit 9b: Target price based on various EPS and P/E multiples, using C\$9.50 for ICI portfolio

(C\$)	P/E (x)	P/E (x)				
		16	14	12	10	8
		EPS (E&C)				
1.60		35.10	31.90	28.70	25.50	22.30
1.70		36.70	33.30	29.90	26.50	23.10
1.80		38.30	34.70	31.10	27.50	23.90
1.90		39.90	36.10	32.30	28.50	24.70

Source: Desjardins Securities

Exhibit 10: Engineering & Construction comparative valuation (March 6, 2009)

Company	Ticker	Share price (\$)	Share price perf (%)				Current		P/E (x)		EPS growth CY/NY (%)	EV/EBITDA (x)		EBITDA growth CY/NY (%)	Curr P/B (x)	CY ROE (%)	CY P/S (x)	Sales growth CY/NY (%)
			5d	1m	3m	6m	Mkt cap (\$m)	EV (\$m)	CY	NY		CY	NY					
Engineering & construction																		
Aecom Tech Corp (US\$)	ACM	21.17	-13.7	-20.7	-23.3	-24.5	2,295	2,494	12.7	10.6	19	6.8	5.9	17	1.55	11.9	0.39	13
Fluor Corp (US\$)	FLR	31.75	-4.5	-23.6	-29.5	-51.2	5,763	3,807	8.4	9.3	-9	3.1	3.5	-11	2.16	23.6	0.25	-5
Foster Wheeler Ltd (US\$)	FWLT	15.15	0.7	-32.4	-29.6	-63.9	1,915	1,386	5.7	6.5	-12	2.9	3.3	-14	4.78	NA	0.31	-7
GENIVAR Income Fund (C\$)	GNV.UN	20.62	-2.1	-14.8	1.0	-20.4	295	376	6.9	6.1	13	6.9	6.1	13	1.72	21.2	0.77	18
Jacobs Eng Group Inc (US\$)	JEC	32.71	-3.1	-22.2	-22.9	-49.3	4,026	3,286	9.1	8.9	2	4.3	4.2	1	1.71	22.8	0.33	3
Shaw Group Inc (US\$)	SGR	22.06	-5.5	-27.1	35.6	-46.7	1,843	2,383	8.8	7.5	17	5.3	5.0	7	1.31	11.1	0.25	7
SNC-Lavalin Group (C\$)*	SNC	29.39	1.2	-20.7	-14.9	-34.5	4,437	5,806	10.2¹	9.9¹	3	8.5	8.4	1	4.07	26.4	0.62	2
Stantec Inc. (C\$)	STN	19.42	-5.0	-33.3	-17.5	-29.9	883	1,028	9.6	8.5	12	5.6	5.1	11	1.64	15.9	0.78	9
Technip SA (EUR)	TEC	24.15	-6.8	-14.5	32.3	-51.3	2,637	1,189	7.3	8.9	-18	1.6	1.9	-13	1.14	13.2	0.34	-8
Tetra Tech Inc. (US\$)	TTEK	21.17	-5.5	-15.3	16.5	-20.9	1,274	1,318	18.3	16.1	14	8.9	8.1	10	2.40	12.9	0.97	10
URS Corp (US\$)	URS	33.82	9.4	-5.9	-7.1	-21.8	2,873	3,789	11.6	10.4	11	5.8	5.5	4	0.78	6.4	0.27	5
Avg engineering & construction			-3.2	-20.9	-5.4	-37.7	2,567	2,442	9.9	9.3	5	5.4	5.2	2	2.11	16.5	0.48	4

* Includes all ICI investments; ¹ Excluding C\$7.00 for 407
 Source: Desjardins Securities, Bloomberg

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Total		117	100	37	100

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Buy

Stocks that are expected to outperform their respective peer group* over a 12-month period

Hold

Stocks that are expected to perform in line with their respective peer group* over a 12-month period

Sell

Stocks that are expected to underperform their respective peer group* over a 12-month period

Not Rated

Stock is being covered exclusively on an informational basis

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Average Risk

Risk represented by the stock is in line with its peer group* in terms of volatility, liquidity and earnings predictability

Above-average Risk

Risk represented by the stock is greater than that of its peer group* in terms of volatility, liquidity and earnings predictability

Speculative

High degree of risk represented by the stock, marked by an exceptionally low level of predictability

* Peer group refers to all of the companies that an analyst has under coverage and does not necessarily correspond to what would typically be considered an industry group. Where an analyst's coverage universe is such that 'relative' performance against a 'peer group' is not meaningful, the analyst will benchmark the rating against the most appropriate market index

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