Asia Credit Research

Keppel Corporation Ltd: Credit Update

Thursday, 03 March 2016

Half Cup Full

- ➢ O&M weakness dominated 2015 results, though property provided some mitigation. Similar trends to persist through 2016.
- ➢ The Sete Brasil situation remains a wildcard, though we believe the ultimate impact on KEP's balance sheet to be controlled. 2015 would have been the worst year in terms of credit profile deterioration.
- ➢ Liquidity looks adequate looking forward, with KEP having several other options aside from tapping capital markets. Retain Issuer Profile at **Neutral**.

- **Brazilian escalation**: Sete Brasil is the largest client as a percentage of the offshore marine ("O&M") order book for both KEP as well as SCI. The Sete Brasil situation has been on a slow boil for some time[1]. Things came to a head recently, with Bloomberg reporting that Sete Brasil was considering seeking bankruptcy protection[2]. Coupled with the continued slump in global energy prices, the negative headlines have resulted in both KEP's and SCI's bonds selling off sharply. With KEP and SCI / SMM not being paid by Sete Brasil since November 2014, and any potential Sete Brasil restructuring placing receivables as well as order books at risk, all eyes were on KEP's 4Q2015 results.

- **O&M weakness dominated 2015 results**: For 2015, KEP saw revenue decline 22.5%y/y to SGD10.3bn. O&M segment was the biggest drag, declining 27.1% to SGD6.2bn (61% of total revenue). O&M revenue has been pressured by requests for delivery delays by end clients. For example, KEP originally had 15 jack-up rigs to be delivered in 2015. In the end, only 7 were delivered, with the balance delayed into 2016. The suspension of work on the Sete Brasil contracts also pressured revenue. Infrastructure revenue declined 29.9% y/y to SGD2.1bn (20% of total revenue). Part of this was due to the Merlimau CoGen as well as Keppel FMO divestment. Property revenue was up 11.4% y/y to SGD2.1bn (19% of total sales), driven by strong sales in China offsetting weak domestic demand in Singapore. In terms of pre-tax profit, we see the reverse, with property segment contribution dominating the O&M segment. Property pre-tax profit was largest at SGD896mn (45% of total pre-tax), a decline of 11.9% y/y due to the lack of divestment gains in 2015 (2014: MBFC, Equity Plaza etc). O&M pre-tax profit dived 48.8% to SGD699mn (35% of total pre-tax profits), driven by the slump in revenue, provision against Sete Brasil contract and overall tighter segment operating profit margins of 13.4% (2014: 14.3%). Infrastructure pre-tax profit plunged as well by 42.4% to SGD256mn. Despite gains from the Merlimau CoGen divestments, KEP recognized about ~SGD200mn losses during 2Q2015 in finalizing the cost to complete the Doha North Sewage Treatment Works project.

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[1] OCBC Asia Credit - Sembcorp Industries - Credit Update – 050315, OCBC Asia Credit – Rig Builders - Credit Update – 250315
[2] http://www.bloomberg.com/news/articles/2016-01-06/btg-backed-rig-venture-said-to-mull-bankruptcy-filing-in-brazil

- **4Q2015 results reflect shift away from O&M**: Quarterly revenue fell 36.8% y/y to SGD2.5bn, led by the 44.3% y/y plunge in O&M revenue to SGD1.3bn (53% of total revenue). In general, the fall in volume of work done and requests for delays has increased. For example, late October 2015, KEP's management indicated that Grupo R has requested to delay two of the five rigs to be delivered in 2015 into 2016. By the time of the recent 4Q2015 earnings brief, it was disclosed that the balance three rigs that were supposed to be delivered to Grupo R in 2015 was also delayed into 2016 at the client's request. Property revenue also fell 22.3% y/y to SGD681mn (now 27% of total revenue), with China sales unable to offset weak domestic demand and the absence of the sale of a Saudi Arabia development done in 4Q2014. Infrastructure revenue fell by 31.3%, mainly due to the lack of contribution due to divestments as well as lower EPC revenue.

- **Property was the earnings clutch**: Strong property pre-tax earnings of SGD442mn (~50% of segment full year pre-tax profits) helped to buffer 4Q2015 earnings, as the other two segments saw more than 80% declines. The segment benefited from fair value gains on investment property (~SGD96mn impact) as well as cost write-backs on Reflections at Keppel Bay. O&M actually generated a net loss of SGD61mn during the quarter, driven by SGD230mn in provisions taken for the Sete Brasil contract. Though earnings slumped for the infrastructure segment, 4Q2014 numbers were boosted by data centre divestment gains, which are non-recurring. In aggregate, with China property fundamentals continuing to look supportive, we expect the property segment to continue to help offset the weakness in O&M through 2016.

- **How deep is the hole**: KEP does not disclose the amount of capital already spent on the Sete Brasil contracts, nor do they provide the profits recognized to date based on work done, as they believe the information to be commercially sensitive. Some information has been disclosed though. For example, KEP has received SGD1.3bn in milestone payments and deposits (10% per semi-sub) from Sete Brasil, though payments have stopped since November 2014. KEP has also "gone slow" on the contracts from 2H2015 onwards and stopped work entirely by end-2015. KEP also reported SGD1.0bn in external sales generated in Brazil for 2015 (note that KEP has other Brazilian contracts, such as the two FPSO contract originally valued at USD950mn for Petrobras). KEP also discloses the state of completion of the Sete Brasil rigs. As such, we can have some estimations regarding the value of the work done

  As of end-2014, the first three semi-subs are 85%, 50% and 25% complete. As of end-2015, there are now four semi-subs being worked on that are 92%, 70%, 40% and 21% complete. As such, for 2015, KEP completed ~63% of one equivalent semi-sub. Given the original contract price of ~USD800mn per semi-sub, and the 10% deposit already paid on the fourth rig, about ~USD424mn, or **~SGD580mn** of work was done (KEP uses percentage of completion method in recognizing revenue) in 2015 and unpaid. This number could be on the larger end, with KEP being more conservative when recognizing revenue, as assumptions are made regarding the recoverability of the contracts. That said, some work was also done during November and December 2014, when Sete Brasil started to halt payments.

  As such, with the provision of SGD230mn made, KEP has already made provisions for ~40% of the work done in 2015, for a balance of **~SGD350mn to account for**. In addition, KEP also has the 10% deposit for the 5th and 6th rig (in which minimum work has been done), which is ~SGD220mn (likely to be part of the SGD1.3bn in receipts that KEP's management already mentioned). This amount could potentially be used to offset the amounts owed by Sete Brasil. That said, management indicated that in the event the contracts get cancelled, KEP would be liable for payments to its own vendors as well.

- **Credit profile impact**: As of end-2015, net gearing jumped from 11% (end-2014) to 53%, driven in part by the ~SGD3bn in cash used to take Keppel Land private. However, on a q/q basis, net gearing was only up slightly from 52%. Gross borrowings for 4Q2015 increased slightly by ~SGD450mn, as KEP generated negative SGD473.8mn in free cash flow during the quarter (due to capex and acquisitions). If we assume that Sete Brasil files for bankruptcy, and that the balance SGD350mn is completely written off, net gearing would increase to ~55%. If we also impair the ~SGD290mn in non-current assets in Brazil (the shipyard BrasFELS) net gearing would increase to ~56%. <u>Ultimately, the stress on KEP's balance sheet would be controlled</u> should the Sete Brasil contracts get cancelled. To get a sense of how net gearing would worsen should other O&M contracts sour, a further SGD1bn provision (on top of the Sete Brasil assumptions we made) would drive net gearing higher ~62%, which again is still manageable. In terms of net debt / EBITDA, it has deteriorated from 3.4x (9M2015) to 3.8x (2015). Given potentially volatile earnings, we can expect the deterioration in net debt / EBITDA to be even more pronounced. In general, we believe that the sharp deterioration in credit profile has already happened in 2015, and will be more controlled in 2016.

- **Liquidity needs to diminish**: For 2015, KEP spent about SGD3bn taking Keppel Land private, SGD1.7bn into capex, acquisition of investment properties as well as investments into associate companies, SGD1.7bn in working capital needs as well as SGD955mn in dividends. To fund this, KEP's cash balance fell by SGD3.8bn, borrowings increased by SGD876mn, divestments such as Merlimau CoGen generated SGD1.3bn while operating cash flow before working capital changes generated SGD1.4bn. Looking forward, we believe that working capital needs would decline given the halt in the Sete Brasil contract. KEP has also announced dividend cuts, saving about ~SGD250mn per annum. It is worth noting that KEP continued to generate positive operating cash flow during 4Q2015. Currently, KEP has ~SGD1.9bn in cash (versus SGD357mn in non-expansionary acquisitions and capex made in 2015, as defined by management), and if there is a need to generate liquidity, it still has the 49% in Merlimau CoGen to divest. KEP also has investments in the REITs it manages, as well as in companies such as M1 which they can potentially monetize. Finally, interest coverage remains healthy at 10.8x and cash / current borrowings remain above 1x.

- **What lurks in the order book**: KEP reported SGD9.0bn in O&M back log, with KEP securing SGD1.8bn in new orders (none of it drilling rigs) for 2015. However, the order book still includes the balance of the Sete Brasil contract (which we estimate to be ~USD3bn). If we exclude these orders, KEP would still have about SGD4.9bn worth of back logs. Of this, more than SGD3.0bn are non-drilling solutions (such as LNG conversions), though an area of worry would be that ~SGD1.5bn worth of orders are jack-up rigs under deferred payment terms. It is worth noting that the lowest level of net order book since 2005 was SGD4.6bn in 2010. We expect the O&M order book to continue to deteriorate given the oversupply in the newbuild rigs. We also believe that customers will continue to seek to delay taking delivery of rigs (delaying the balance 80% payment), while seeking for contracts to utilize these rigs. An area that we will continue to monitor would be order cancellations resulting from client stress, something that is already affecting Sembcorp Marine.

- **Recommendation**: After reviewing KEP's 2015 results, as well as considering the impact of any Sete Brasil restructuring on KEP's balance sheet, we believe that the resulting deterioration to KEP's balance sheet would be controlled. KEP's cash burn would likely taper in 2016, and we believe that KEP has adequate levers to pull to generate liquidity without needing to tap capital markets. As such, we will retain our Issuer Profile at **<u>Neutral</u>**.

  As mentioned early, KEP's and SCI's curves have sold off, driven by both O&M

sector pressures as well as idiosyncratic risk due to Sete Brasil. In general, the current market environment remains weak, with the withdrawal of liquidity widening bid-ask spreads. That said, we believe that negative technical factors have overwhelmed fundamentals, and will attempt to consider where the bonds should trade.

	30/09/15 prices				**Current prices**		
	Bid	Ask	Mid Spread		**Bid**	**Ask**	**Mid Spread**
KEPSP'20	100	101	57bps		**98.65**	**99.15**	**105bps**
KEPSP'22	99.5	100.5	56bps		**96.0**	**98.0**	**125bps**
KEPSP'23	N/A	N/A	N/A		**97.0**	**99.0**	**144bps**
KEPSP'27	99.5	100.5	98bps		**93.0**	**96.0**	**177bps**
KEPSP'42	95.0	96.5	110bps		**85.5**	**90.0**	**182bps**

Indicative prices as of 28/01/16, KEPSP'23s were issued in November

A potential curve to consider would be Neptune Orient Lines ("NOL") after it divested its APL Logistics business and paid down debt, but before news of a potential Temasek sale (around the middle of July 2015) caused the curve to sell off. NOL shares several similarities with KEP and SCI. All three have sizable Temasek ownership, which caused their credit spreads to be tighter than what their credit profile may suggest. All three are facing a challenging operating environment for one of their core businesses. All are large companies generating more than SGD5bn in annual revenue, and hence are of a certain scale. In all these aspects though, NOL has performed worse. For example, NOL has been loss making for years, its net gearing post the APL Logistics divestment remains elevated at ~103%, much higher than where we believe KEP would deteriorate to, and both KEP and SCI are more diversified relative to NOL. As such, KEP should not be trading at levels wider than NOL.

As of 30/06/15, NOLSP'20s were trading at a mid-spread of 202bps above swaps. Looking at other Temasek-linked issuers like Capitaland and Singtel, their spreads have widened by ~25bps above swaps since 30/06/15, which we can use to approximate the worsening of market sentiment since 30/06/15. As such, NOLSP'20 (pre-Temasek divestment) could be trading at a mid-spread of ~230bps today. Given the continued negative sector headwinds, coupled with the evolving Sete Brasil situation dominating headlines, it is difficult to call for fair value. However, in our view, even after factoring an onerous outcome for the Sete Brasil situation, along with some other O&M provisions, the 5-year portion of the SCI curve should not be trading wider than ~200bps mid spread above swaps while the equivalent part of the KEP curve should be trading tighter than SCI by at least ~20bps, hence a mid-spread of no wider than 180bps.

It would seem that the longer-end of the curve has sold off more intensely than the shorter end of the curve. With this in mind, for our bond recommendations, we continue to hold our Underweight on the KEPSP'20s and KEPSP'22s, move the KEPSP'23s to Neutral while going Overweight the KEPSP'27s and KEPSP'42s.

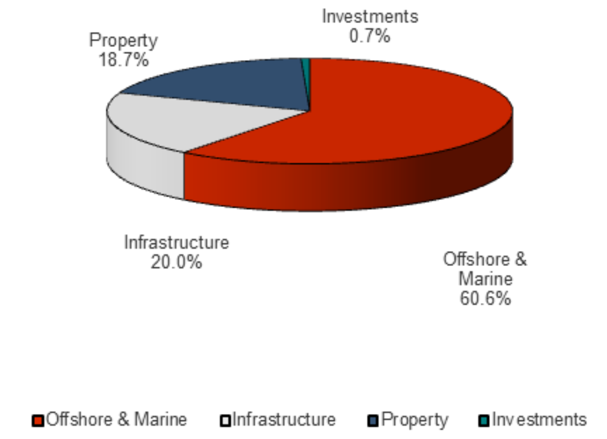
Keppel Corporation Ltd

Table 1: Summary financials

Year ended 31st December	FY2013	FY2014	FY2015
Income statement (SGD' mn)			
Revenue	12,380.4	13,283.0	10,296.5
EBITDA	2,108.5	2,305.4	1,673.1
EBIT	1,866.2	2,040.3	1,426.0
Gross interest expense	124.7	134.0	154.8
Profit Before Tax	2,793.7	2,888.6	1,997.4
Net profit	1,845.8	1,884.8	1,524.6
Balance Sheet (SGD'mn)			
Cash and bank deposits	5,564.7	5,736.0	1,892.8
Total assets	30,055.6	31,554.8	28,932.1
Gross debt	7,099.5	7,382.5	8,258.7
Net debt	1,534.9	1,646.5	6,365.8
Shareholders' equity	13,688.9	14,727.6	11,925.9
Total capitalization	20,788.4	22,110.2	20,184.5
Net capitalization	15,223.7	16,374.2	18,291.7
Cash Flow (SGD'mn)			
Funds from operations (FFO)	2,088.1	2,149.9	1,771.7
CFO	624.7	4.7	-705.0
Capex	936.1	594.9	1,147.0
Acquisitions	576.3	667.4	581.8
Disposals	567.2	1,728.6	1,504.4
Dividends	843.1	1,028.5	955.7
Free Cash Flow (FCF)	-311.4	-590.2	-1,852.0
Adjusted FCF*	-1,163.7	-557.6	-1,885.1
Key Ratios			
EBITDA margin (%)	17.0	17.4	16.2
Net margin (%)	14.9	14.2	14.8
Gross debt/EBITDA (x)	3.4	3.2	4.9
Net debt/EBITDA (x)	0.7	0.7	3.8
Gross debt/equity (x)	0.52	0.50	0.69
Net debt/equity (x)	0.11	0.11	0.53
Gross debt/total capitalization (%)	34.2	33.4	40.9
Net debt/net capitalization (%)	10.1	10.1	34.8
Cash/current borrowings (x)	10.8	3.2	1.1
EBITDA/gross interest (x)	16.9	17.2	10.8

Source: Company, OCBC estimates
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

Figure 1: Revenue breakdown by operations – FY2015



Source: Company

Figure 2: Revenue breakdown by geography – FY2015

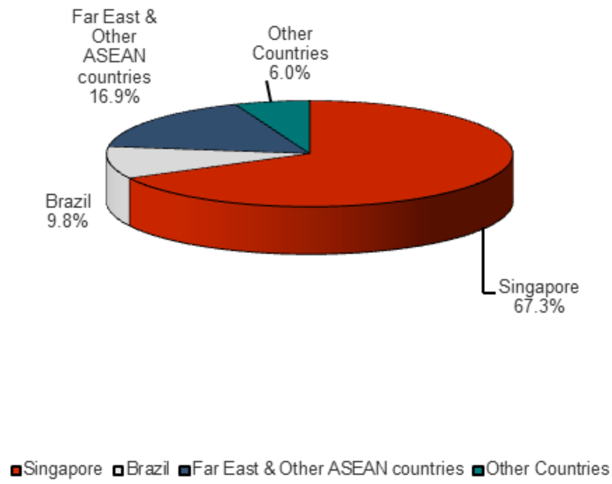
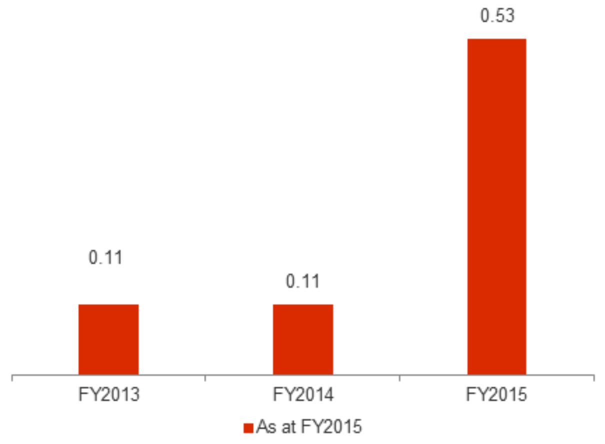


Figure 3: Debt maturity profile

Amounts in SGD mn	As at 31/12/2015	% of debt
Amount repayable		
One year or less, or on demand		
Secured	11.8	0.1%
Unsecured	1645.0	19.9%
After one year		
Secured	1216.9	14.7%
Unsecured	5385.0	65.2%
Total	**8258.7**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company

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