Asia Credit Research

# Sembcorp Industries Ltd: Credit Update

**Friday, 06 May 2016**

## From Jack-Ups to Generators

- **O&M contribution continues to fall**: 1Q2016 results showed total revenue declining 18.9% y/y to SGD1.9bn. This was largely driven by the offshore marine ("O&M") segment (effectively Sembcorp Marine, ("SMM")), which saw segment revenue falling 29.5% y/y to SGD918.4mn. O&M revenue is now ~50% of total revenue, compared to ~54% (end-2014). The segment continues to be pressured by the slump in energy upstream activities impacting demand for newbuild drilling assets. Specifically, revenue generated from drilling assets (rigs & floaters) fell 43.0% y/y to SGD540.0mn. It is worth noting though that the decline in SCI's O&M revenue was lower than the decline in Keppel's O&M revenue (which fell 57.6% y/y). Operating margins were pressured by lower revenue recognition and higher depreciation, compressing to 7.8% (1Q2015: 10.6%). As such, net profit contribution from the O&M segment fell from 45% of total net profit (1Q2015) to 31%. With revenue from utilities looking to ramp up heading into the rest of 2016, we can expect O&M's contribution to remain suppressed for the rest of the year.

- **More utilities capacity coming online**: The utilities segment was also soft, with segment revenue declining 6.6% y/y to SGD895.0mn due to the domestic power business. Spark spreads continue to be pressured by competition while HSFO prices were also lower impacting SembGas. Looking forward though, things look on track for more of SCI's international utilities going operational. SCI has also been increasing its stakes in its India power projects. For example, during 1Q2016, SCI increased their stake in Sembcorp Gayatri Power Ltd ("SGPL") from 49% to 65%, and will be increasing the stake further to 88% in 2Q2016 (the stake increase from 49% is expected to cost SCI ~SGD134mn). SGPL is SCI's second thermal power project in India, with a capacity of 1340MW, and is expected be completed in phases in 2016. The first project, TCPIL, was fully completed in September 2015. One area of uncertainty would be the profitability of these projects. Net profit from SCI's India utility projects was a loss in 1Q2016, as the long-term power purchase agreement which TCPIL signed was only effective from April 2016 onwards. Management had also previously indicated that the expected ROE on TPCIL was ~10%. India currently contributes ~24% of total utilities revenue.

- **Operating cash flow generation improving:** Including interest expense, operating cash flow was negative SGD16.6mn, a distinct improvement over the negative SGD742.1mn generated in 4Q2015. The O&M segment was the cash drag, with SMM generating negative SGD72.9mn in operating cash flow due to working capital needs for on-going rig building projects. SCI spent SGD192.9mn on capex as well during the quarter, with SMM accounting for roughly half of the spending (its Tuas expansion and Brazil yard). As such, FCF was still negative SGD209.5mn for the quarter, though sharply better than the negative ~SGD1bn in FCF the previous quarter. Acquisitions (such as the increase in stake in SGPL) were SGD41.4mn net use of cash. These were funded by ~SGD610mn increase in net borrowings (SCI / SMM increased their cash balance). The bulk of the borrowings were done at the SMM level.


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- **Leverage profile hit by SGPL consolidation**: As SCI increased its stake in SGPL from 49% to 65% during the quarter, SCI now consolidates SGPL's financials into its statements. SMM also increased its stake in Gravifloat from an associate to a subsidiary during the period. In aggregate, these acquisitions increased SCI's total assets from SGD19.9bn (end-2015) to SGD21.6bn (end-1Q2016). Total liabilities increased as well from SGD11.9bn (end-2015) to SGD13.4bn (end-1Q2016). The consolidation of SGPL onto SCI's balance sheet was the main driver for gross borrowings to increase by 24.6% q/q to SGD8.5bn. This was largely driven by SGD1.2bn in additional project finance debt. <u>As such, net gearing jumped higher from 65% to 80% q/q</u>. We acknowledge though, that the capital structure for SGPL was standard project financing, rather than an indication of SCI having a higher debt tolerance. Net debt / EBITDA improved though to 5.9x (2015: 8.5x), as 4Q2015 impairments / provisions impacted EBITDA. The improvements to EBITDA also helped increase interest coverage from 2.6x (2015) to 3.2x (1Q2016). Cash / current borrowings now stand at 1.2x due to the increase in cash balance, helping to alleviate some liquidity pressure. Looking forward, we believe that the cash flows generated from the ramping up of the India power business will support liquidity.

- **O&M order book is as expected**: Net O&M order book has declined from SGD10.4bn (end-2015) to SGD9.7bn (end-1Q2016), with SMM winning SGD60mn in new contracts during the quarter for LNG modules fabrication. It is worth noting that Sete Brasil has filed for bankruptcy protection towards the end of April 2016, and that the balance of Sete Brasil's contracts is still in the O&M order book. SMM has commenced arbitration proceedings against Sete Brasil to protect its own interests[1]. SCI's management did discuss the bankruptcy filing by Sete Brasil during the 1Q2016 earnings briefing and reiterated that the provisions taken during 4Q2015 are adequate. We have previously reviewed SCI / SMM's exposure to Sete Brasil[2]. Aside from Sete Brasil, other O&M clients have also continued to seek relief. For example, SMM and Transocean have agreed to further delay the two ultra deepwater drillships which Transocean had ordered from SMM. Transocean had already deferred the orders once in June 2015, with the deliveries pushed from 2Q2017 / 1Q2018 to 2Q2019 / 1Q2020. The drillship deliveries have now been further deferred to 1Q2020 / 3Q2020. The contract value for these drillships is ~SGD1.4bn.

- **Recommendation**: Though SCI's credit profile has deteriorated, this was largely driven by the consolidation of SGPL onto SCI's balance sheet. We continue to believe that the deterioration to SCI's credit profile will be more muted relative to 2014 and 2015 and hence will retain our Issuer Profile at <u>**Neutral**</u>. That said, we expect the dispersion in credit profile between KEP and SCI to widen, as it would take a longer time for SCI to monetize its utilities business compared to KEP's property business. Like KEP, SCI's curve has rallied strongly since selling off at the beginning of 2016. Investors that have taken positions through the volatility might want to consider taking profit on the longer end of the curve.

| | 01/02/16 prices | | | | **Current prices** | | |
|---|---|---|---|---|---|---|---|
| | Bid | Ask | Mid Spread | | **Bid** | **Ask** | **Mid Spread** |
| SCISP'20 | 98 | 101 | 194bps | | **101.25** | **102** | **140bps** |
| SCISP'24 | 97 | 99 | 175bps | | **98** | **99.25** | **156bps** |
| SCISP'26 | 92 | 94 | 173bps | | **97** | **99** | **137bps** |
| SCISP 4.75'49 | 91 | 94.25 | 456bps | | **100.25** | **100.75** | **271bps** |
| SCISP 5'49 | 95.5 | 98.5 | 410bps | | **101** | **101.75** | **269bps** |

Indicative prices as of 05/05/16. *Perpetual securities: spread to call.

[1] http://www.straitstimes.com/business/sembcorp-begins-arbitration-proceedings-against-sete-brasil
[2] OCBC Asia Credit - Sembcorp Industries - Credit Update - 240216

We have been adjusting our bond recommendations on SCI's curve based on valuation[3], and are currently Underweight the SCISP'20s and SCISP'26s, while holding the rest of the curve Neutral.

[3] OCBC Asia Credit Monthly (May 2016)

# Sembcorp Industries Ltd

**Table 1: Summary financials**

| Year ended 31st December | FY2014 | FY2015 | 1Q2016 |
|---|---|---|---|
| **Income statement (SGD' mn)** | | | |
| Revenue | 10,894.7 | 9,544.6 | 1,895.2 |
| EBITDA | 1,377.0 | 612.2 | 279.7 |
| EBIT | 1,062.2 | 207.3 | 178.9 |
| Gross interest expense | 70.1 | 238.0 | 86.3 |
| Profit Before Tax | 1,246.4 | 426.3 | 160.9 |
| Net profit | 801.1 | 548.9 | 107.0 |
| **Balance Sheet (SGD'mn)** | | | |
| Cash and bank deposits | 1,661.4 | 1,606.5 | 1,927.1 |
| Total assets | 17,176.4 | 19,915.5 | 21,563.4 |
| Gross debt | 4,841.1 | 6,832.9 | 8,510.5 |
| Net debt | 3,179.6 | 5,226.5 | 6,583.5 |
| Shareholders' equity | 7,232.3 | 8,043.5 | 8,204.2 |
| Total capitalization | 12,073.3 | 14,876.4 | 16,714.7 |
| Net capitalization | 10,411.9 | 13,270.0 | 14,787.7 |
| **Cash Flow (SGD'mn)** | | | |
| Funds from operations (FFO) | 1,115.9 | 953.8 | 207.8 |
| CFO | -119.8 | -1,061.8 | -16.6 |
| Capex | 1,337.8 | 1,392.8 | 192.9 |
| Acquisitions | 267.6 | 640.6 | 43.9 |
| Disposals | 23.4 | 704.8 | 3.4 |
| Dividends | 549.1 | 439.6 | 12.5 |
| Free Cash Flow (FCF) | -1,457.7 | -2,454.5 | -209.5 |
| Adjusted FCF* | -2,251.0 | -2,829.9 | -262.5 |
| **Key Ratios** | | | |
| EBITDA margin (%) | 12.6 | 6.4 | 14.8 |
| Net margin (%) | 7.4 | 5.8 | 5.6 |
| Gross debt/EBITDA (x) | 3.5 | 11.2 | 7.6 |
| Net debt/EBITDA (x) | 2.3 | 8.5 | 5.9 |
| Gross debt/equity (x) | 0.67 | 0.85 | 1.04 |
| Net debt/equity (x) | 0.44 | 0.65 | 0.80 |
| Gross debt/total capitalization (%) | 40.1 | 45.9 | 50.9 |
| Net debt/net capitalization (%) | 30.5 | 39.4 | 44.5 |
| Cash/current borrowings (x) | 1.5 | 0.9 | 1.2 |
| EBITDA/gross interest (x) | 19.6 | 2.6 | 3.2 |

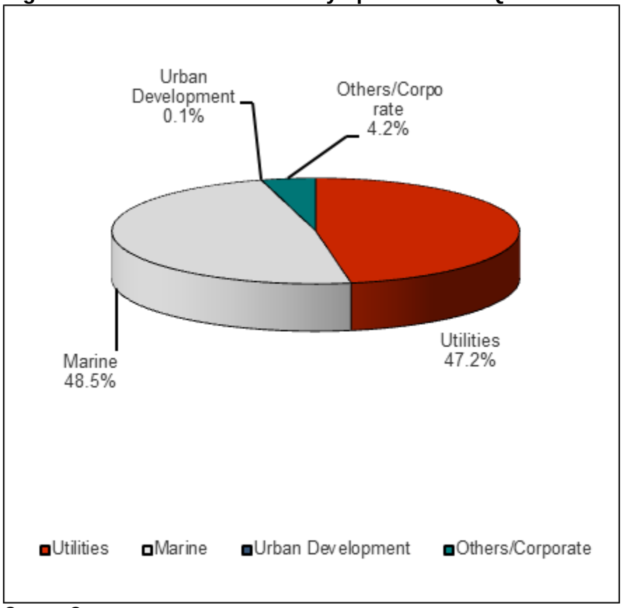
*Source: Company, OCBC estimates*
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

**Figure 3: Debt maturity profile**

| Amounts in SGD mn | As at 31/03/2016 | % of debt |
|---|---|---|
| **Amount repayable** | | |
| One year or less, or on demand | | |
| Secured | 795.4 | 9.3% |
| Unsecured | 825.0 | 9.7% |
| After one year | | |
| Secured | 2656.3 | 31.2% |
| Unsecured | 4233.8 | 49.7% |
| **Total** | **8510.5** | **100.0%** |

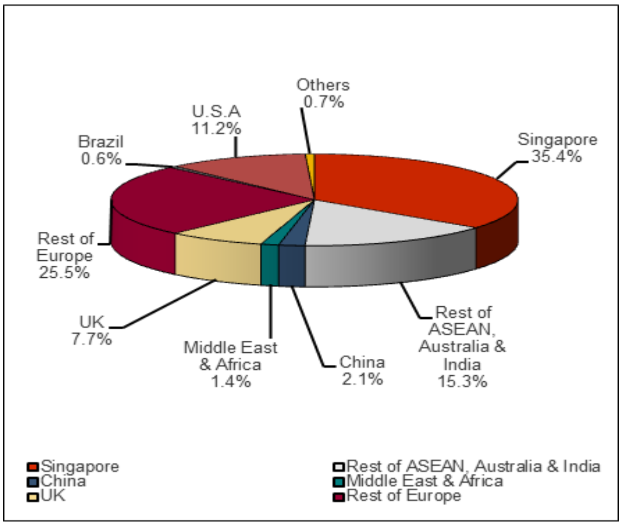
*Source: Company*

**Figure 1: Revenue breakdown by operations – 1Q2016**



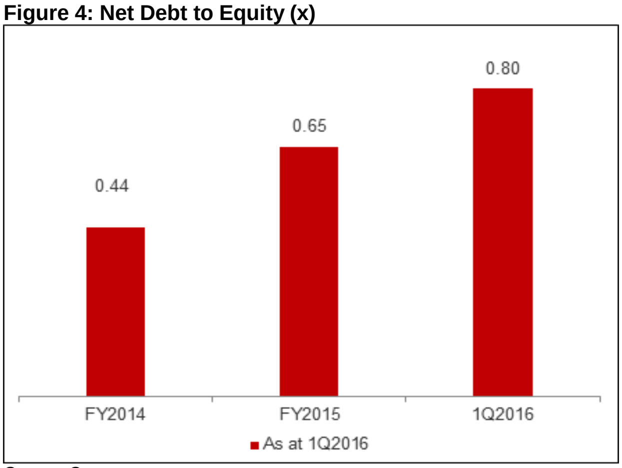

*Source: Company*

**Figure 2: Revenue breakdown by geography – 1Q2016**




*Source: Company*

**Figure 4: Net Debt to Equity (x)**




*Source: Company*