Asia Credit Research

OCBC Bank

Sembcorp Industries Ltd: Credit Update

Wednesday, 17 August 2016

Can't Catch a Break

- **Surprises out of India**: With the offshore marine ("O&M") segment facing sector headwinds, SCI is reliant on its overseas utilities performance to help offset O&M performance. With both units of Thermal Powertech Corporation India ("TPCIL", 1320MW) operational since March and September 2015 respectively, and absence of floods which affected 2H2015 performance, 1H2016 was expected to reflect a stronger showing. However, 2Q2016 was weakened by TPCIL's unit 2 facing equipment failure, and hence was offline in April and May. This caused TPCIL's average plant load factor to fall from 83% (1Q2016) to 69% (2Q2016). In addition, in the short-term, India is actually facing an oversupply situation, with CEA forecasting a 1.1% surplus for fiscal year ending March 2017 (1228bn units of supply versus 1215bn units of demand). Though SCI expects long-term demand trends to support the market going forward, in the interim, the surplus markets has pressured spot tariffs as well as limited the availability of long-term PPAs (which SCI is seeking for its Sembcorp Gayatri Power Limited, ("SGPL", 1320 MW) generating units coming online in 2H2016). As a result, for 2Q2016, India contribution to the utilities performance was SGD208.6mn in revenue and SGD4.0mn in net profit.

- **Future trends remain intact**: For the utilities segment in total, revenue was down 20.4% y/y to SGD894.7mn while operating profit fell 19.2% to SGD131.2mn. The domestic power business remains weak given intense competition (pressuring spark spreads) and lower HSFO prices. Looking forward, things are a bit brighter, with SCI having signed a long-term PPA for 86% of TPCIL's net capacity. SGPL has also targeted the commercial operational date for its two units to be 3Q2016 and 4Q2016 and has secured some short-term PPAs. When fully ramped up, India would likely generate ~SGD2bn in utilities revenue per annum, slightly lower than domestic utilities revenue. In fact, with O&M looking to remain weak in the near future, utilities contribution could become the largest revenue generator in the near future. Already, 1H2016 revenue contributions from both segments are roughly equal at ~SGD1.8bn each.

- **Stuck in a Quagmire**: O&M segment revenue fell 24.8% y/y to SGD908.0mn. Based on Sembcorp Marine ("SMM")'s disclosures, the slump in O&M revenue was driven by lower revenue recognized on rig building projects due to customers' delivery deferment requests. The slump in revenue also compressed gross margins to 11.7% (2Q2015: 16.5%). Demand for drilling assets remains very weak due to oversupply, with the new orders won YTD all non-drilling related (SGD140mn in offshore platforms, SGD180mn in floaters). The net order book (excluding SGD3.2bn balance of Sete Brasil contract) stands at USD6.0bn. This is higher than Keppel Corp ("KEP")'s SGD4.3bn O&M net order book. Of the USD6.0bn in net order book, we estimate that less than USD2bn are drilling assets. We believe that some of these orders are vulnerable. For example, Perisai Petroleum Teknologi ("PPT") has two jackup rigs on order from SMM, to be delivered later in 2016 (the delivery dates for these rigs have already been delayed). PPT has written off ~SGD140mn on prepayments made for these two rigs when PPT reported its full-year 2015 results. Management has reiterated that

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the SGD329mn in provisions made regarding Sete Brasil and SGD280mn in provisions taken regarding other contracts remain adequate.

- **Sete Brasil Update**: On 12/08/16, Sete Brasil filed its draft restructuring plan to the bankruptcy court. As part of the plan, Sete Brasil would complete between 8 to 12 rigs (out of an original order of 28 rigs). To finance this, Sete Brasil is seeking USD5bn in fresh financing[1]. Comparatively, SMM and KEP were contracted to build 7 drillships and 6 semi-submersible respectively. We believe that the restructuring process would be protracted, particularly given the on-going “car wash” corruption investigation into Petrobras’ vendors. Sete Brasil’s next steps would be to seek creditor approval for the plan.

- **Operating cash flow seeing improvements**: SCI’s total revenue declined 22.7% y/y to SGD1.8bn. Net profit plunged 65.3% y/y to SGD94.8mn, in part due to divestment gains recognized in 2Q2015 (SGD54.7mn gain from the sale of SBWI). Higher financing expenses (+61.4% y/y) due to higher borrowings as well as FX losses have also dragged down the bottom line. Operating cash flow (net of interest service) continues to improve q/q, from negative SGD16.6mn to positive SGD66.0mn. However capex remains high at SGD297.7mn (about 30% due to O&M, the balance due to utilities as a result of investments in its Indian power business). As such, free cash flow remained negative for the quarter at SGD231.7mn (1Q2016: negative 209.5mn). In addition, SCI paid out SGD107.2mn in dividends during the quarter. The cash gap was funded by both additional borrowings as well as by drawing on SCI’s cash balance.

- **Leverage profile to stabilize**: Due to additional borrowings, net gearing continues to grind higher to 86% (1Q2016: 80%). On a net debt / EBITDA basis though, it remains stable at 5.8x (1Q2016: 5.9x) while interest coverage remained stable as well at 3.3x (1Q2016: 3.2x). Cash / current borrowings stands at 1.1x. Looking forward, SMM has reported that it would be receiving cash for deliveries made during July 2016 (specifically the Noble Lloyd Noble rig as well as fixed platform projects), resulting in SGD909mn in operating cash flow. In addition, SMM believe that its working capital needs have peaked, and that gearing at current levels should improve through the balance of 2016. As a result, we believe that SCI’s credit profile should stabilize as well (given that SGPL has already been consolidated onto SCI’s books in 1Q2016). As such, we will retain our Issuer Profile at **<u>Neutral</u>**. Currently, based on valuation, we are Neutral on the SCISP’20s as well as the two perpetual securities, and are Underweight the rest of the SCI curve.

[1] http://www.reuters.com/article/sete-restructuring-idUSL1N1AT25S

Sembcorp Industries

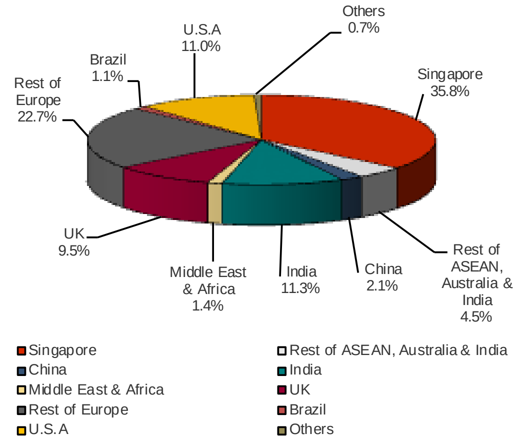
Table 1: Summary Financials

Year End 31st Dec	FY2014	FY2015	1H2016
Income Statement (SGD'mn)			
Revenue	10,894.7	9,544.6	3,741.7
EBITDA	1,377.0	612.2	587.6
EBIT	1,062.2	207.3	372.5
Gross interest expense	70.1	238.0	177.6
Profit Before Tax	1,246.4	426.3	283.9
Net profit	801.1	548.9	193.5
Balance Sheet (SGD'mn)			
Cash and bank deposits	1,661.4	1,606.5	1,682.8
Total assets	17,176.4	19,915.5	21,620.1
Gross debt	4,841.1	6,832.9	8,526.9
Net debt	3,179.6	5,226.5	6,844.1
Shareholders' equity	7,232.3	8,043.5	7,966.9
Total capitalization	12,073.3	14,876.4	16,493.8
Net capitalization	10,411.9	13,270.0	14,811.0
Cash Flow (SGD'mn)			
Funds from operations (FFO)	1,115.9	953.8	408.6
CFO	-119.8	-1,061.8	49.4
Capex	1,337.8	1,392.8	490.6
Acquisitions	267.6	640.6	51.0
Disposals	23.4	704.8	25.9
Dividend	549.1	439.6	155.0
Free Cash Flow (FCF)	-1,457.7	-2,454.5	-441.2
FCF adjusted	-2,251.0	-2,829.9	-621.2
Key Ratios			
EBITDA margin (%)	12.6	6.4	15.7
Net margin (%)	7.4	5.8	5.2
Gross debt to EBITDA (x)	3.5	11.2	7.3
Net debt to EBITDA (x)	2.3	8.5	5.8
Gross Debt to Equity (x)	0.67	0.85	1.07
Net Debt to Equity (x)	0.44	0.65	0.86
Gross debt/total capitalisation (%)	40.1	45.9	51.7
Net debt/net capitalisation (%)	30.5	39.4	46.2
Cash/current borrowings (x)	1.5	0.9	1.1
EBITDA/Total Interest (x)	19.6	2.6	3.3

Source: Company, OCBC estimates

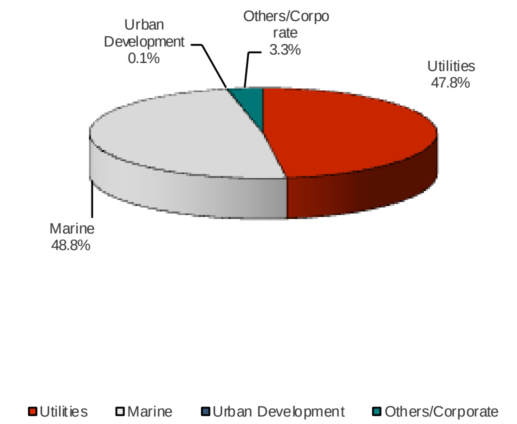
* *FCF Adjusted = FCF - Acquisitions - Dividends + Disposals*

Figure 1: Revenue breakdown by Geography - 1H2016



Source: Company

Figure 2: Revenue breakdown by Segment - 1H2016



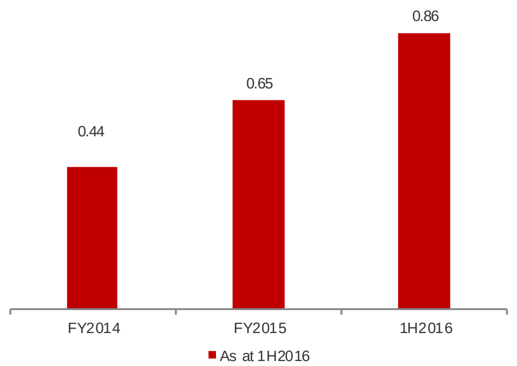
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 30/06/2016	% of debt
Amount repayable in one year or less, or on demand		
Secured	750.8	8.8%
Unsecured	755.0	8.9%
	1505.8	**17.7%**
Amount repayable after a year		
Secured	2633.8	30.9%
Unsecured	4387.3	51.5%
	7021.1	**82.3%**
Total	**8526.9**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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