Asia Credit Research

OCBC Bank

CK Hutchison Holdings Ltd: Credit Update

Monday, 28 August 2017

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- **CKHH is in the midst of an Infrastructure segment-led shopping spree though divestment and special dividends from Power Assets Holdings help keep credit profile defensible.**
- **CKHH continues to be diversified. Overlaying geographical regions with business division, only two business segments contribute more than 10% to proportionate EBITDA, namely, UK Infrastructure and European Telecommunications.**
- **Telecommunications results boosted by the WindTre merger in Italy. We see signs pointing towards expansion of capex in the medium term.**
- **FY2016's negative same-store sales in the China Watson business were a concern, though company is responding to changing landscape with some success.**
- **Recommendation:** On the back of its steady credit profile**,** we are maintaining CKHH's issuer profile at **Neutral**. We are keeping our underweight call on the SGD-denominated CKHH 3.408%'18s (Ask YTM 1.29%, 13bps spread) and prefer Henderson Land's HENLND 4% '18s. Within the intermediate USD curve for CKHH, we prefer the CKHH '22s against other maturities.

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- **Background:** CK Hutchison Holdings Ltd ("CKHH") has released its 1H2017 financial results. In July 2017, the company announced the proposed acquisitions of infrastructure assets (up to HKD18.9bn) and the divestment of the fixed line telecommunications business in Hong Kong. This follows HKD31.2bn in investing cash outflows in 1H2017. We have analysed the 1H2017 results of CKHH and considered the impact of such proposed asset movements in our credit update.

  CKHH is a conglomerate listed on the Hong Kong Stock Exchange ("HKEX") with a market cap of HKD391.9bn as at 25 August 2017. It tracks its origins to business houses set up in the 1800s and has been through transformations over the decades. Today, CKHH is pillared by Infrastructure and Telecommunications which make up 63% of proportionate EBITDA (including proportionate contribution from joint venture and associates). Other important segments include Retail, Ports and Related Services and Energy. CKHH hold significant stakes in eight listed companies, of which CK Infrastructure Holdings Limited ("CKI") is the largest, with a market cap of HKD187.1bn. CKI owns a 38.87% stake in Power Assets Holdings ("PAH"), which in turn owns a 33.37% stake in HK Electric Investments Limited ("HK Electric"). Both PAH and HK Electric are separately listed on the HKEX. Despite being listed in Hong Kong, 57% of the CKHH's proportionate EBITDA comes from Europe (including the UK). The largest shareholders of CKHH are Mr. Li Ka Shing and family, holding around 30%-stake in CKHH (including via trusts).

Figure 1: CKHH SGD Bond

Issue	Maturity / First Call Date	Outstanding Amount (SGDmn)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating / Guarantor Rating
CKHH 3.408% '18	20-Jul-18	320	101.875	1.27	11	A-/A3/A-

Note: (1) Indicative prices as at 28 August 2017

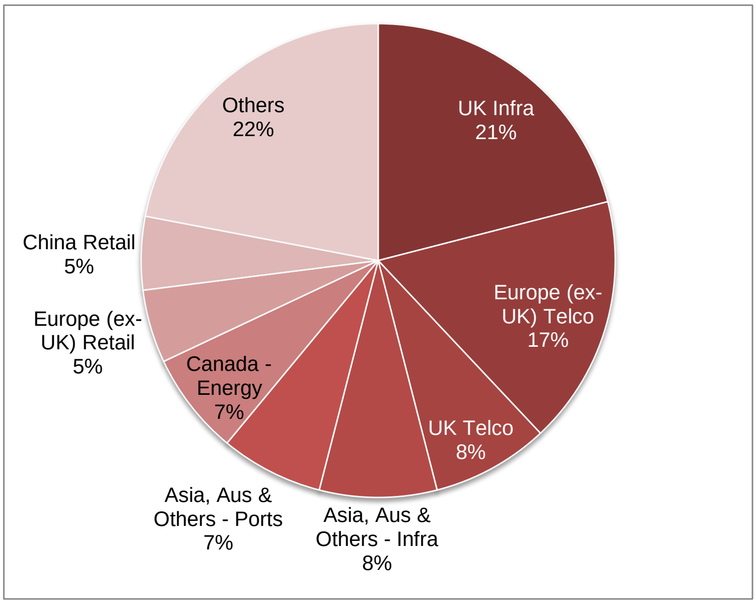
Figure 2: CKHH USD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDmn)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating / Guarantor Rating
CKHH 7.625% '19	09-Apr-19	1,500	108.9	1.96	43	A-/A3/A-
CKHH 5.75% '19	11-Sep-19	1,000	107.3	2.07	50	A-/A3/A-
CKHH 3.25% '22	08-Nov-22	500	103.4	2.54	71	A-/A3/A-
CKHH 4.625% '22	13-Jan-22	1,430	108.5	2.56	79	A-/A3/A-
CKHH 2.875% '22	05-Apr-22	1,000	101.1	2.52	83	A-/A3/A-
CKHH 3.625% '24	31-Oct-24	1,500	104.7	2.90	93	A-/A3/A-
CKHH 3.5% '27	05-Apr-27	800	103.4	3.09	99	A-/A3/A-
CKHH 7.5% '27	01-Aug-27	329	135.7	3.25	114	A-/A3/A-

Note: (1) Indicative prices as at 28 August 2017

- **Overall performance in 1HFY2017 steady:** Including proportionate contribution from JVs and associates, CKHH reported a 5% increase in revenue to HKD190.1bn in HKD terms (up 9% in local currency terms). EBITDA (including proportionate contribution) in HKD terms was up 2% to HKD45.3bn, largely attributable to growth in 3 Group Europe (contribution from the Wind Tre joint venture in Italy), acquisitions made in the Infrastructure segment and improvements in the performance of Husky Energy. This was partly offset by lower contribution of the telecommunications segment in Asia. In local currency terms, proportionate EBITDA would have increased 7% y/y. Overlapping key geographical regions with business divisions, there are 22 main business segments which make up CKHH's proportionate EBITDA. Only two segments contributed more than 10% to proportionate EBITDA, namely (1) UK Infrastructure contributing one-fifth of proportionate EBITDA. Assets in this segment are largely regulated infrastructure with revenues pegged to inflation and (2) Europe (excluding UK) telecommunications (ie: 3 Group Europe) contributing 17% of proportionate EBITDA.

Figure 3: Key Business Segments



Note: (1) Proportionate EBITDA of HKD45.3bn in 1H2017
(2) Others: Segments whose contribution to proportionate EBITDA is individually less than 5%

- **Infrastructure operating companies generally more levered than CKI:** CKHH's infrastructure business mainly consists of its ~72%-stake in CKI (75.67% economic interest based on profit sharing ratio) and direct stakes in six other CKI-led infrastructure consortiums. A typical transaction structure for CKI's large scale investments is to co-own acquired companies with its associates and other related parties (including Li family entities falling outside the CKHH structure). Going forward, we think CKI would increasingly acquire projects with Cheung Kong Property Holdings ("CKP") (to be renamed to CK Asset Holdings Limited). CKP falls outside the CKHH structure but is 31.47%-owned by the Li family. It was originally carved out to hold property assets though CKP has since re-strategized to focus on infrastructure investment and aircraft leasing. As CKHH and CKI holds the bulk of its infrastructure operating companies as joint ventures, debt at the infrastructure operating companies are not consolidated into the balance sheet of CKHH. As an illustration, based on Moody's latest reports, Wales & West Utilities and Northern Gas Networks had a net debt over regulated asset base of 0.72x and 0.65x respectively as at 31 March 2016. It is not unusual for regulated infrastructure companies to have higher leverage levels, though as a comparison, CKI's net debt-to-total assets was only 0.14x as at 30 June 2017.

- **CKI driven by UK though getting more diversified:** In 1H2017, CKI made HKD5.7bn in profit after tax ("NPAT"). Main contributors to NPAT at CKI are its UK portfolio and 38.87%-stake in PAH. Based on our estimates, UK assets (including PAH's UK exposure) contributed HKD3.7bn to CKI's NPAT. PAH's non-UK assets (including the stake in HK Electric, Australia, China and other countries) contributed HKD756mn to CKI. In 1H2017, Australia contributed HKD834mn in NPAT to CKI (representing about 15% of total NPAT). This includes the 1.5 months contribution from the 40%-stake in DUET Group held directly by CKI. On a pro-forma basis assuming that the full contribution of DUET Group was included into 1H2017 numbers, we estimate that Australia would have contributed ~20%-25% to CKI's NPAT. We expect CKI's reliance on UK to decrease post its stake acquisition in Ista (a European-based smart metering business) and Reliance LP, a provider of heating, cooling and water services company in Canada.

- **Ports and related services so far dependable in the face of a consolidating shipping sector:** Per Dewry, a maritime consultancy, CKHH is the second largest port operator globally by TEU handled (adjusted for proportionate equity stake). The ports segment contributed HKD5.7bn, representing 13% of CKHH's proportionate EBITDA. This segment is driven by container throughput at its berths and is relatively stable. Since 2014, the segment had contributed HKD5.5bn-6.0bn in proportionate EBITDA and handled 40-42mn TEU semi-annually. In 1H2017, throughput had increased by 3% to 41.1mn TEU y/y mainly due to growth in Mainland China, Hong Kong, Barcelona and Pakistan, offsetting declines in Rotterdam, Jakarta and Damman. Key assets within the segment include CKHH's 27.6%-stake in Hutchison Port Holdings Trust ("HPH Trust") and operating berths that are outside the HPH Trust structure. HPH Trust holds CKHH's berths in Kwai Chung, Guangdong and Shenzhen. HPH Trust, Mainland China and Hong Kong operations contributed 23% to port EBITDA while 52% was attributable to ports in Asia, Australia and other countries. On-going large-scale consolidation among shipping companies and competition among ports (eg: between Kwai Tsing versus ports in the hinterland) are likely to lead to intensified pricing pressures going forward.

- **Inorganic growth in European Telco:** CKHH's Telco business is focused on Europe (Italy, Sweden, Denmark, Austria and Ireland) and in the UK via the "3 Group brand". The UK and Europe collectively contribute 89% of total telecommunications EBITDA and make up 25% of total proportionate EBITDA in 1H2017. In November 2016, the merger between CKHH's Italian business, namely 3 Italia S.p.A and VimpelCom Ltd's and Wind Telecomunicazioni ("Wind") was completed, with the inorganic growth added into 1H2017 results. The merger saw the formation of a 50:50 joint venture (ie: WindTre) created. In 1H2017, telco EBITDA grew by 33% y/y, largely attributable to the additional contribution from this joint venture. Sweden, Denmark and Austria saw healthy improvements in EBITDA, driven by improvements in top line and cost containments. Ireland saw EBITDA declining 6% in local currency terms (integration pains with O2 Ireland, increase churn due to new pricing policies). In local currency terms, UK EBITDA was dragged down 2% by higher operating costs despite posting strong growth in active customers. Excluding customers from Italy, we find total active customers at 45.3mn as at 30 June 2017, up 5% against the same time last year. Active customers on contract (tend to be stickier) dipped slightly to 70% of total against 71% in 1H2016.

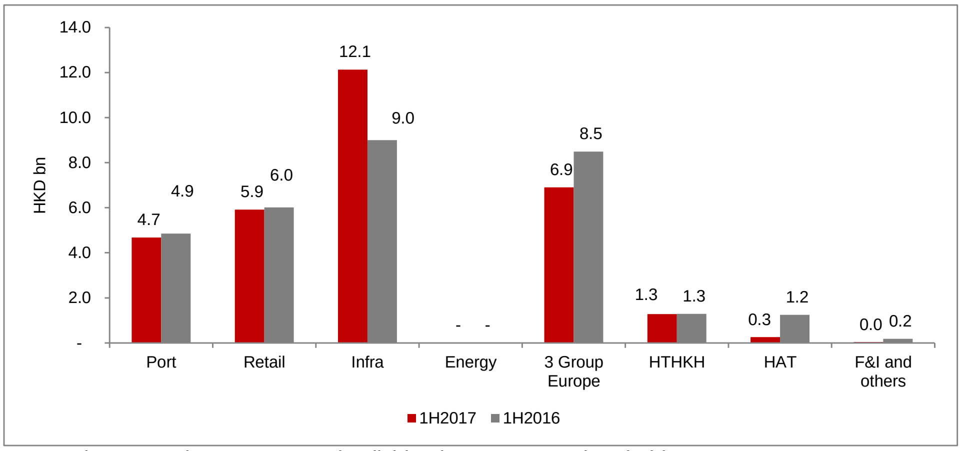
- **Low telco capex unlikely sustainable in the medium term:** In 1H2017, the European telco segment only spent HKD2.8bn in capex, slightly above depreciation & amortisation and lower than the HKD4.2bn spent in 1H2016. Whilst the universal specification of the next generation of mobile networks ("5G") has not been finalised, draft specifications has been released. Europe is perceived to be lagging behind in deployment. Live trials among mobile operators have commenced in USA, Japan South Korea and Australia in the past few months while handset makers such as Apple, Samsung, Huawei and Nokia are currently testing new technologies. According to the Next Generation Mobile Networks Alliance ("NGMN Alliance"), an industry group, 5G technology is likely to go mainstream by 2020. The European Commission reportedly estimates the total capex number across the region at EUR57bn (~HKD526bn) though telecommunications executives generally think the number would be higher. Concerns over costs of investments amidst slower revenue growth persist among European mobile operators. Net-net though, we think such concerns only delay deployment. It would be a matter of time before exponential growth in data needs and regulators would motivate mobile operators to invest.

- **Retail - stemming negative same-store growth in China:** In 1H2017, CKHH's retail segment contributed HKD6.5bn (14% of total proportionate EBITDA). This was a 1% decline in HKD terms though in local currency, EBITDA had improved 3%. 94% of Retail EBITDA is attributable to the Health & Beauty segment (of which 35% was from China). Health & Beauty commands a formidable retail network spanning ~13,050 stores globally (~5,650 stores in China and rest of Asia under the "Watsons" brand and 7,400 stores in Europe). AS Watson, the holding company of the retail business was proposed to be listed, though the plans were scrapped when Temasek bought a 25%-stake in the business in 2014. Health & Beauty performed stronger in Europe and rest of Asia (Hong Kong, Southeast Asia, Taiwan, Turkey etc), which saw comparable store sales grow 2.7% and 3.2% respectively. Health & Beauty China struggled in FY2016 with comparable sales growth down 10.1% though efforts to stem the decline saw some results, with 2Q2017 same store growth narrowing to a negative 2.7%. Despite the still-negative same store growth, EBITDA margins in China remains strong at 21% (1H2016: 22%). The rise of online retailing is a generalised concern for brick-and-mortar retailers. Nonetheless, we think Watsons should benefit from its physical store network following impending changes in retail beyond a pure online model. In our view, impulse buys (which are affected by positive shopping experiences) is still an important contributor in Health & Beauty product categories and this is more achievable in physical stores. Additionally, the company has been responding to landscape changes via developing its own online site, selling via JD.Com and Tmall and introducing more exclusive and private label products. Per AS Watson's COO, customers who buy both from physical and online stores spend 2.5x-3.0x more than those who only buy from physical stores, a sign that cannibalisation of online versus offline is manageable.

- **No dividend upstream from Husky Energy:** This segment relates to CKHH's 40.2% stake in Husky Energy (separately listed on the Toronto Stock Exchange). 29.3% of the company is owned by the Li family. In 1H2017, the Energy segment (via Husky Energy) reported proportionate revenue of HKD21.2bn and EBITDA of HKD4.0bn. During the six months, results at the Energy segment was driven mainly by higher upstream commodity prices, higher contributions from the increased production of higher margin thermal developments though this was partly offset by lower downstream contribution, planned turnarounds in certain refineries and an impairment charge. In 1H2017, Husky Energy produced 326.7 mboe/day down 1% y/y. The company continues to focus on reductions in cost structure, such that the oil price needed to breakeven on earnings is reduced. Each new project at Husky Energy would need to be at breakeven (zero internal rate of return "IRR") at an oil price of USD35 WTI and must generate an IRR of 10% at USD45 WTI. In April 2016, Husky Energy sold a portion of its oil pipeline and storage assets to its sister companies. This helped unlock CAD1.7bn (HKD10.6bn) and strengthened its balance sheet. 48.75% was sold to PAH and 16.25% was sold to CKI respectively. At the Husky Energy level, gross gearing was 30% in end-2016, falling from 41% in end-2015. As at 30 June 2017, cash balances was SGD2.5bn while gross gearing was 34%. Since the beginning of 2016, Husky had halted dividend payments following the plunge in WTI since 3Q2014. While the company's financials are on stronger footing, dividends did not resume in 2Q2017. We think resumption of dividends, when it happens, will occur at lower quantum than what Husky shareholders had been historically used to (ie: CAD1.17 per share, HKD1.3bn in 1H2015 attributable to CKHH). Attracted by the asphalt production capabilities, in August 2017, Husky announced the proposed acquisition of Superior Refinery for USD435mn (~HKD3.4bn) in cash. Our base case assumes that the acquisition will be funded at the Husky level without equity outlay from CKHH.

- **Operating cash flow steady, Infrastructure makes up bulk of investing outflows:** We sum up actual dividends received from associates and joint ventures with consolidated EBITDA to get a proxy for cash flow from operations before interest, tax and working capital ("CFO"). In 1H2017, CKHH's CFO was HKD31.2bn, relatively steady against 1H2016. Infrastructure was the most significant contributor at 39%, up 10 ppt from 1H2016, followed by 3 Group Europe (22%), Retail (19%) and Port (15%). During 1H2017, CFO/Interest paid was 6.8x, somewhat above the 6.6x in 1H2016. CKHH reported investing outflows of HKD31.2bn in 1H2017 (up from HKD8.7bn in 1H2016). The increase was largely attributable to CKI's 40%-stake acquisition in DUET Group amounting to HKD17.3bn. No significant acquisitions/investments were made in 1H2016, with investing outflows mostly related to maintenance capex.

Figure 4: CFO Breakdown by Segment



Note: Husky Energy has not resume its dividend payments to shareholders

- **Aggregate leverage up but still healthy:** As at 30 June 2017, CKHH's headline net gearing was 0.32x (up slightly from 0.28x in end-2016) though within historical levels. With a short term debt of only HKD40.3bn against cash of HKD150.2bn, refinancing risk at CKHH is minimal. In end-2016, capex commitment and operating lease commitments at CKHH was HKD67.1bn and the company expressed that there are no material changes in such commitments except where certain amounts have been taken up with the passage of time. Contingent liabilities (inclusive of guarantees to associates and joint ventures, performance and other guarantees) were HKD7.1bn as at 30 June 2017. Adjusting net debt upwards to account for HKD72.1bn in commitments and contingent liabilities, we find adjusted net debt/equity healthy at 0.45x (end-2016: 0.41x).

- **Significant pending acquisitions though credit profile to stay defensible:** Post 1H2017, CKHH's had announced two proposed acquisitions and one divestment. All three transactions are pending shareholders approval. The two Infrastructure acquisitions (via CKI) is likely to cost the company up to HKD18.9bn. On 20 July 2017, PAH announced that it will be paying HKD8.27 per share in dividends to shareholders (including a HKD7.50 in one-off special dividend). CKI owns 38.87% in PAH and we expect its share of the dividend to amount to HKD6.9bn. Additionally on 30 July 2017, CKHH's 66%-owned Hong Kong telecommunications business, namely Hutchison Telecommunications Hong Kong ("HTHKH") announced that it will be selling its fixed line business for HKD14.5bn in cash. A special dividend from HTHKH could also be paid out, in which case CKHH may receive up to ~HKD9.6bn. We assume the declared dividend from PAH and a possible dividend from HTHKH is used to offset the impending acquisition cost. This would result in a minimal cash gap of HKD2.4bn. On 16/08/2017, CKI had issued USD500mn (HKD3.9bn) in perpetuals which can go towards funding. In our view, CKHH's headline net gearing is likely to stay relatively constant at 0.3x. Our base case assumes that the divestment of the HTHKH fixed line business will reduce CFO by HKD670mn though this can be offset by contributions from new acquisitions, leading to CFO/Interest paid of 6.8x – 7.0x. We expect the new acquisitions to be cashflow generative in the outset, given they are matured Infrastructure assets. In June 2017, the Retail arm was also reportedly looking to acquire a major health foods retailer for ~HKD9.9bn, though there has been no news since then, possibly due to valuation issues.

Figure 5: Announced Proposed Acquisitions and Divestment

Month	Asset	Description	Investment Outlay by CKHH
July 2017	• Reliance LP • Building equipment services provider	• **Infrastructure:** CKI has entered into an agreement with CKP to purchase a 25%-stake in this company • CKP sits outside the CKHH group structure	CAD715mn (HKD4.4bn)
July 2017	• Ista Luxemburg GmbH ("Ista") • Energy management services provider, smart-metering	• **Infrastructure:** CKI and CKP has entered into an agreement to acquire 100% in Ista • CKI to hold 35% of Ista • CKP sits outside the CKHH group structure	Maximum financial commitment EUR1.575bn (HKD14.5bn)
July 2017	• Fixed-line telecommunication business of HTHKH	• **Telecommunications:** Sale of business unit to private equity firm • CKHH owns 66% of HTHKH	Cash proceeds for HKD14.5bn Gain of HKD5.8bn at the HTHKH level

- **Recommendation:** We are maintaining a **<u>Neutral</u>** issuer profile on CKHH, on the back of its steady credit profile despite the impending acquisitions and divestment. We are keeping the SGD-denominated CKHH 3.408%'18s (Ask YTM 1.27%, 11bps spread) at Underweight. Within the CKHH USD curve, we prefer the CKHH '22s which we think is fair against peers.

  We have considered the following:

A) SGD-denominated HENLND 4% '18s is trading at an Ask YTM of 1.42% (23 bps spread). While HENLND is unrated, we see its credit profile as comparable to CKHH. We hold HENLND's issuer profile at Neutral.
B) The CKHH 7.625 '19s are trading a spread of 43bps is tight against the SWIRE 5.5 '19s at 55bps and the CKHH 5.75% '19s at 50bps.
C) The CKHH 2.875% '22s, CKHH 3.25% '22 and CKHH 4.625% '22s are trading fair against issuers with a similar rating scale, the SWIRE 4.5% '22s and SUNHUN 4.5% '22s.
D) The CKHH 3.5% '27 (spread of 99bps) and CKHH 7.5%'27s (spread of 114bps) is trading tight against the SWIREPRO 3.625% '26, with a spread of 113bps.
E) We do not cover Swire Pacific, Swire Property and Sun Hung Kai.

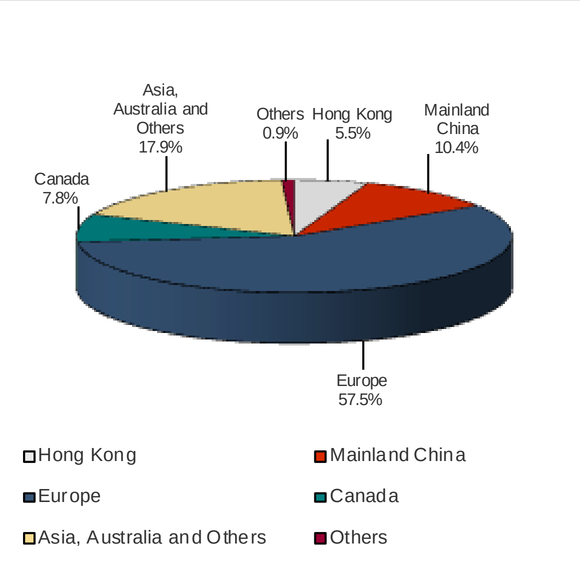
CK Hutchison Holdings Ltd

Table 1: Summary Financials

Year Ended 31st Dec	FY2015	FY2016	1H2017
Income Statement (HKD'mn)			
Revenue	166,760	259,842	117,755
EBITDA	34,300	53,326	22,843
EBIT	24,682	37,312	15,605
Gross interest expense	4,566	7,444	4,066
Profit Before Tax	127,775	46,463	20,598
Net profit	118,570	33,008	15,919
Balance Sheet (HKD'mn)			
Cash and bank deposits	121,171	156,270	150,223
Total assets	1,032,944	1,013,465	1,052,838
Gross debt	308,379	307,423	329,751
Net debt	187,208	151,153	179,528
Shareholders' equity	549,111	544,190	558,658
Total capitalization	857,490	851,613	888,409
Net capitalization	736,319	695,343	738,186
Cash Flow (HKD'mn)			
Funds from operations (FFO)	128,188	49,022	23,157
* CFO	44,549	40,338	22,202
Capex	25,482	24,546	8,751
Acquisitions	-88,510	2,486	21,627
Disposals	3,876	3,347	106
Dividends	13,756	16,365	11,451
Free Cash Flow (FCF)	19,067	15,792	13,451
* FCF Adjusted	97,697	288	-19,521
Key Ratios			
EBITDA margin (%)	20.6	20.5	19.4
Net margin (%)	71.1	12.7	13.5
Gross debt to EBITDA (x)	9.0	5.8	7.2
Net debt to EBITDA (x)	5.5	2.8	3.9
Gross Debt to Equity (x)	0.56	0.56	0.59
Net Debt to Equity (x)	0.34	0.28	0.32
Gross debt/total capitalisation (%)	36.0	36.1	37.1
Net debt/net capitalisation (%)	25.4	21.7	24.3
Cash/current borrowings (x)	3.7	2.2	3.7
EBITDA/Total Interest (x)	7.5	7.2	5.6

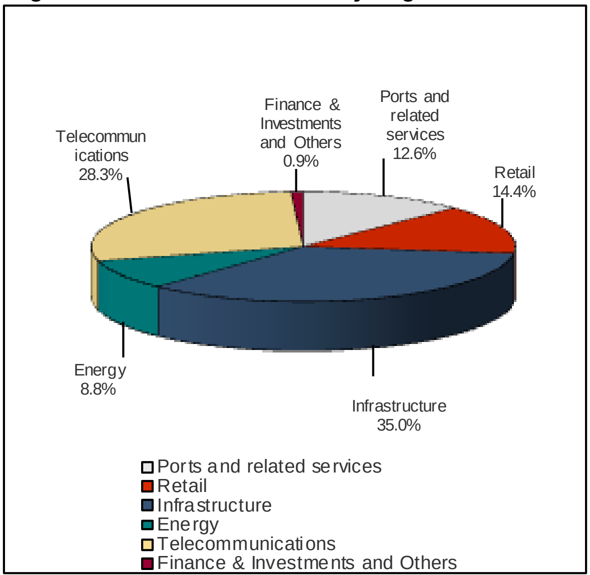
Source: Company, OCBC estimates
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 1: EBITDA breakdown by Geography - 1H2017



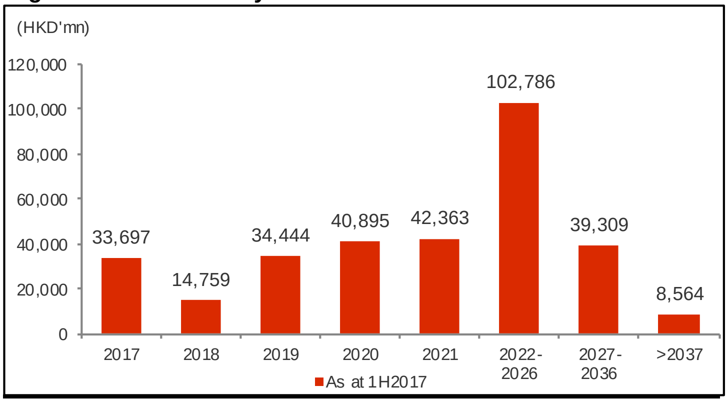
Source: Company | Chart shows proportionate revenue

Figure 2: EBITDA breakdown by Segment - 1H2017



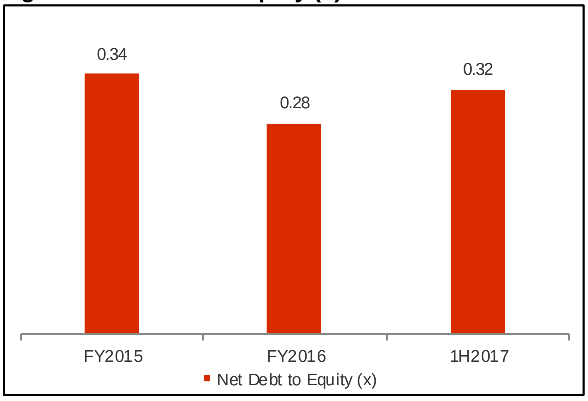
Source: Company | Chart shows proportionate EBITDA

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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