Asia Credit Research

OCBC Bank

Olam International Limited: Credit Update

Friday, 24 March 2017

Evergreening of debt to continue

- **Free cash flow post capex and investments still negative, though has narrowed significantly.**
- **Net gearing has reached the internal threshold of 2.0x and our base case assumes expanded use of perpetual as replacement capital should OLAM continue to grow its asset base.**
- **Low free float means amounts that can be fundraised from public equity market is constrained without major shareholder support.**
- **Until we see operating cash flow generation from existing assets improve, debt pare down is unlikely to be meaningful (net gearing to stay around current levels).**

- **Recommendation:** We are underweight the OLAMSP 4.25%'19 which is 10 bps tighter than the OLAMSP 5.8%'19. We are also underweight the OLAMSP 6.0%'18 and are neutral the rest of the SGD curve. On the more actively traded USD curve, we are neutral on the OLAMSP 5.75%'17 (short maturity of 6 months) and neutral on the OLAMSP 7.5%'20. We are Underweight the rest of the USD curve and see (1) Further widening of 20bps on the OLAMSP 4.375%'23, OLAMSP 5.35%49c21 and OLAMSP 4.5%'21 (2) Further widening of 60bps on the OLAMSP 4.5%'20. This bond matures only 6 months before the OLAM 7.5%'20s.

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OCBC Credit Research
Ezien Hoo, CFA
+65 6722 2215
EzienHoo@ocbc.com

- **Background:** OLAM has released its unaudited financial statements for FY2016. OLAM's cash flow post capex and investments have improved (albeit still negative) though gearing levels have risen. We are keeping OLAM's issuer profile on **Neutral**, though this is premised on continuous support by Temasek and Mitsubishi. OLAM's low free float of ~18% constraints the amount of public equity that can be raised (valuation of public shareholder stake ~SGD920mn). Without pro-rata participation, Temasek and Mitsubishi's shareholding will be diluted (we expect knock-on effects on bond prices should this happen). Temasek is rated at AAA/Aaa/NR and Mitsubishi Corp is rated at A/A2/NR (with a Negative outlook[1]).

OLAM, incorporated in Singapore, is listed on the Singapore Stock Exchange with a market cap of SGD5.1bn (as at 23 March 2017). OLAM is 52.2%-owned by Temasek and 20.3%-owned by Mitsubishi Corporation. Public holders hold ~18% of the company (including one institutional owner holding a 7.8% block). OLAM is a diversified, vertically-integrated agri-commodities merchandiser, producer and trader. It also generates income from the sale of packaged foods, commodity financial services and holding minority stakes in longer term investments. OLAM operates across 70 countries and has leadership positions in cocoa, coffee, cashew, rice and cotton.

[1] *Moody's A2 rating incorporates uplift from Mitsubishi Corp's underlying credit profile (indicated rating from grid: Baa2 in the next 12-18 months) due to expectation of continuous funding from Japanese banks*

Figure 1: OLAM SGD Bonds Outstanding

Issue	Maturity / Next Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
OLAMSP 6.0%'22	25 Oct 2022	485	104.8	5.00	289	NR/NR/NR
OLAMSP 7.0%49c17	1 Sept 2017	235.8	101.4	3.49	241	NR/NR/NR
OLAMSP 4.25%'19	22 Jul 2019	400	101.0	3.79	219	NR/NR/NR
OLAMSP 5.8%'19	17 Jul 2019	350	104.0	3.95	235	NR/NR/NR
OLAMSP 6.0%'18	10 Aug 2018	250	103.7	3.21	182	NR/NR/NR

Note: (1) Indicative prices as at 23 March 2017

- **Stronger EBITDA generation and lack of exceptional loss drive profits:** In FY2016, OLAM reported revenue of SGD20.6bn against SGD19.1bn in 12M2015[2]. This was driven by top line growth in the Confectionary and Beverage, Food Staples and Packaged Food and Industrial Raw Materials, Ag Logistics & Infrastructure ("IRM") segments. This helped offset a 6% revenue decline in the Edible Nuts, Spices and Vegetable Ingredients ("Edible Nuts and SVI") segment. EBITDA (based on the company's calculation)[3], saw an increase of 10.8% to SGD1.2bn. This was driven by higher EBITDA contribution from Confectionary and Beverage and Food Staples and Packaged Food (collectively up SGD241.4mn) which offset the declines from Edible Nuts, Spices and SVI, IRM and Commodity Financial Services ("CFS") (collectively down SGD123.8mn). OLAM recorded finance costs of SGD446.2mn, falling 20% from SGD557.1mn (annualised from 18M2015[4]). This was driven by overall lower borrowing costs as OLAM bought back high cost debt in 2015. EBITDA/Interest was healthier at 2.7x against 2.1x in 12M2015. Exceptional losses narrowed significantly in FY2016 at only a loss of SGD12.5mn against a SGD397mn loss in 12M2015. In 12M2015, OLAM recorded a large fair valuation loss on its investment in PureCircle Limited, dairy farming restructuring and other one-off losses. In FY2016, profit before tax at OLAM was SGD433.4mn against a small loss before tax of SGD27.3mn in 12M2015. Nevertheless, OLAM recorded other comprehensive losses of SGD424.0mn during the year, driven by a negative foreign currency translation adjustment (negative SGD306.1mn), largely from the fall of the Nigerian Naira, hedging losses and loss on fair value changes (collectively, negative SGD98.3mn). Net-net, OLAM recorded a total comprehensive loss of SGD84.9mn which dragged book value equity.

- **Basic net gearing reaches internal threshold of 2.0x:** As at 31 December 2016, OLAM's net debt-to-equity ("net gearing") was 2.0x (31 December 2015: 1.9x). Based on the company's calculation using book value equity before fair value adjustment reserves, net gearing was 1.99x as at 31 December 2016. After events of late-2012, OLAM had announced a strategic review and one of the priorities was to reduce gearing to at or below 2.0x. In FY2016, OLAM's gross debt was up SGD1.4bn (representing an 11.2% growth) against an increase in book value equity of 5.9%. In July 2016, OLAM raised USD500mn (~SGD693mn) in perpetuals, which helped cap basic net gearing from breaching 2.0x. Perpetuals are treated as equity in OLAM's financials. Conservatively though, we accounted 50% of perpetuals as debt, given the existence of a dividend stopper and OLAM has historically paid dividends to equity holders. We find adjusted net gearing at 2.3x (31 December 2015: 2.0x). Perpetuals now make up about 5% of total capital. As OLAM has reached its 2.0x internal threshold, our base case assumes that the company will expand the use of perpetuals should it continue to pursue asset growth. Adjusting basic net debt downwards for Readily Marketable Inventory ("RMI")[5], which OLAM considers as near-cash, and secured receivables[6], we find net gearing at 0.8x (31 December 2015: 0.7x).

[2] OLAM changed its financial year end to December from June. We have referred to information provided in the Management Discussion & Analysis for this paragraph to compare FY2016 results against that of the 12 months ended December 2015 ("12M2015").
[3] Includes net gains/(losses) in fair value of biological assets, other income and share of results from jointly controlled entities and associates, but excludes exceptional items
[4] 18 months ended December 2015
[5] For OLAM, RMI are liquid, hedged and/or sold forward, operating as near-cash assets on its balance sheet
[6] For OLAM, secured receivables are receivables supported by letters of credit or documents through banks

- **Changing nature of the supply chain business:** OLAM's business is becoming more integrated along the value chain, in particular post its acquisition of ADM Cocoa. We expect to see more working capital carried for the captive processing business (Mid/Downstream value chain) versus being carried for OLAM's physical trading business (in the Supply Chain). In FY2016, EBITDA from the mid/downstream value chain contributed 52% of total EBITDA (12M2015: 30%). Per company, the margin which had been traditionally booked under the Supply Chain is now booked under the Mid/Downstream. EBITDA/Invested Capital for the Confectionary & Beverage Ingredient segment (a ratio which OLAM uses to track segment performance) was 6.9% in FY2016, slightly improved from 6.4% in 12M2015. OLAM had targeted for the acquisition to reach steady-state from FY2018, with the combined business reaching EBITDA/Invested Capital of 12-13%. As at 31 December 2016, OLAM considered SGD5.9bn (out of SGD7.4bn) of its inventories as RMI. As cocoa beans sourced would need to be kept as inputs for the Mid/Downstream segment, we expect a lower proportion of inventories to be considered RMI without jeopardising the business as a whole going forward.

- **Debt and perpetual help fund dividends and share buy-backs:** In FY2016, OLAM reported stronger cash from operations (before tax and interest) of SGD1.0bn, against only SGD154.9mn in 12M2015. In 12M2015, OLAM completed the transformational acquisition of ADM Cocoa and the company took on significant amounts of working capital. While we take some comfort that CFO has improved, we believe that working capital on OLAM's balance sheet commingle those from newly acquired subsidiaries. There is no certainty that working capital would stay constant given its business nature and penchant for acquisitions. For FY2016, OLAM recorded a SGD1.4bn cash outflow from investing activities, about SGD704mn lower than 12M2015. OLAM invested in the setting up of an animal feed mill, poultry breeding farm and a hatchery in Nigeria, acquired Amber Foods (wheat milling and pasta manufacturing assets) and Brooks (a peanut sheller) in the US, among major capex spent during the year. We find a cash gap of SGD765.8mn post cash flow used for investing activities. OLAM's net borrowings were SGD513.2mn while proceeds from perpetuals were SGD659.3mn (after netting perpetual distributions). In effect, perpetuals and new debt was used to partially fund investing outflows as well as payments to shareholders. In FY2016, SGD278.4mn in cash was paid to shareholders (via dividends and share buy-backs). The company would continue to be shareholder friendly, in our view.

- **Short term refinancing risk controllable:** As at 31 December 2016, gross debt at OLAM stood at SGD13.7bn. This consisted of SGD6.0bn in short term debt and SGD7.7bn in long term debt. In March 2017, OLAM issued a USD300mn (~SGD420mn) bond maturing in January 2023 which can be used for refinancing of its short term debt. In March 2017, OLAM announced that it will call the OLAMSP 7.0%49c17 SGD perpetual in September 2017 (outstanding amount of SGD236.8mn). Assuming the recent bond is used to pay down short term debt, OLAM faces SGD5.8bn in short term obligations. Apart from the OLAMSP5.75%'17 (outstanding amount of USD500mn), bulk of the remaining short term debt is made up of bank loans. In our view, these are largely working capital in nature and hence can be rolled-over and/or refinanced. As at December 2016, OLAM has SGD7.4bn in unutilised bank lines which should help. We see low risk of non-payment on both the SGD perpetual and USD500mn bond due in September 2017 given OLAM's cash balance of SGD2.1bn (of which SGD1.3bn sits at the issuer level). Nevertheless, we think it is likelier for a fundraising exercise to fund repayment (our base case via perpetuals).

- **Debt likely to cost higher and we do not expect meaningful paring down of debt:** 46% of total long term debt (including the new 2023 USD bond) is made up of bonds/medium-term notes with bullet maturity. The remainder are largely bank debt. Per company, its invested capital are largely still gestating and/or partly contributing (yet to reach steady-state). Until we see further improvements in cash flow from existing assets, we expect OLAM to manage its maturity schedule by constantly tapping the debt markets. OLAM does not disclose its weighted average cost of debt. We estimate this at ~3.3%. Assuming 20% of total debt is refinanced each year, a 100bps increase in interest rates leads to ~SGD30mn additional interest expense p.a. Our base case assumes SGD450-500mn of interest expense annually and debt is not meaningfully pared down. We take some comfort though that secured debt only make up 1% of total debt. Based on our estimation of tangible assets, we find gross debt/tangible assets of 0.8x.

- **Recommendation:** We are underweight the OLAMSP 4.25%'19 which is 10 bps tighter than the OLAMSP 5.8%'19. We are also underweight the OLAMSP 6.0%'18 and are neutral the rest of the SGD curve. On the more actively traded USD curve, we are neutral on the OLAMSP 5.75%'17 (short maturity of 6 months) and neutral on the OLAMSP 7.5%'20. We are Underweight the rest of the USD curve and see (1) Further widening of 20bps on the OLAMSP 4.375%'23, OLAMSP 5.35%49c21 and OLAMSP 4.5%'21 (2) Further widening of 60bps on the OLAMSP 4.5%'20. This bond matures only 6 months before the OLAM 7.5%'20s.

We have considered the following:

A) In our view, Louis Dreyfus is the closest peer to OLAM although from a technical standpoint, OLAM benefits from its parentage. The LOUDRE 4.0%'20s are trading at an implied SGD Ask YTM at 4.6%
B) The company has announced that it will call on the SGD perpetual, OLAMSP 7.0%49c17 come September 2017
C) OLAM's USD curve has widened since mid-March 2017 and we expect further widening

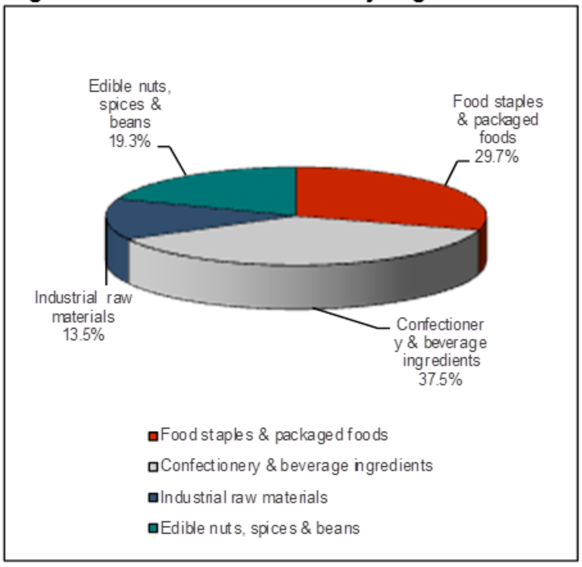
Olam International Ltd

Table 1: Summary Financials

	Year End 31st Dec	FY2014	FY2015*	FY2016
	Income Statement (SGD'mn)			
	Revenue	19,772.0	28,230.6	20,587.0
**	EBITDA	1,061.5	1,610.2	1,202.8
	EBIT	851.7	1,223.1	849.3
	Gross interest expense	492.2	727.8	446.2
	Profit Before Tax	728.6	174.1	433.4
	Net profit	591.0	54.2	351.3
	Balance Sheet (SGD'mn)			
	Cash and bank deposits	1,236.0	2,143.2	2,144.1
	Total assets	15,522.8	20,854.9	23,468.9
	Gross debt	9,113.3	12,293.9	13,670.6
	Net debt	7,877.2	10,150.7	11,526.5
	Shareholders' equity	3,901.6	5,319.7	5,634.3
	Total capitalization	13,014.9	17,613.6	19,304.9
	Net capitalization	11,778.9	15,470.4	17,160.8
	Cash Flow (SGD'mn)			
	Funds from operations (FFO)	800.8	441.3	704.8
^	CFO	-95.0	-518.7	619.6
	Capex	442.8	565.9	755.8
	Acquisitions	82.6	1,958.8	588.1
	Disposals	512.6	341.0	32.0
	Dividend	190.0	247.3	184.0
	Free Cash Flow (FCF)	-537.9	-1,084.7	-136.2
^	FCF adjusted	-297.9	-2,949.8	-876.4
	Key Ratios			
	EBITDA margin (%)	5.4	5.7	5.8
	Net margin (%)	3.0	0.2	1.7
	Gross debt to EBITDA (x)	8.6	7.6	11.4
	Net debt to EBITDA (x)	7.4	6.3	9.6
	Gross Debt to Equity (x)	2.34	2.31	2.43
	Net Debt to Equity (x)	2.02	1.91	2.05
	Gross debt/total capitalisation (%)	70.0	69.8	70.8
	Net debt/net capitalisation (%)	66.9	65.6	67.2
	Cash/current borrowings (x)	0.4	0.4	0.4
	EBITDA/Total Interest (x)	2.2	2.2	2.7

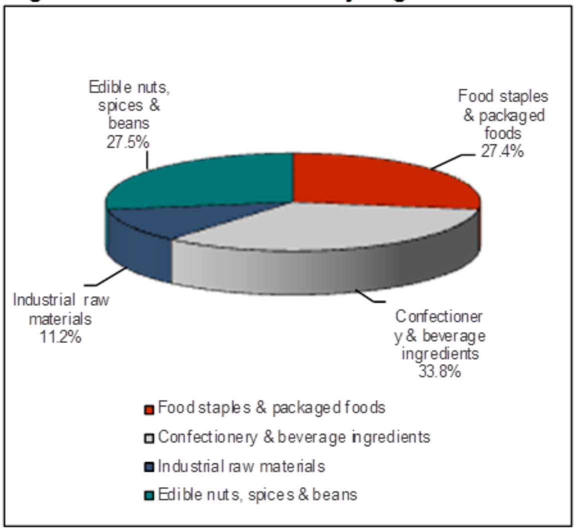
*Source: Company, OCBC estimates | *FY2015 figures are 18 months numbers ended 31 Dec 2015*
*** EBITDA according to Company's definition.*
^FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | ^CFO after deducting interest e

Figure 1: Revenue breakdown by Segment - FY2016



Source: Company

Figure 2: EBITDA breakdown by Segment - FY2016



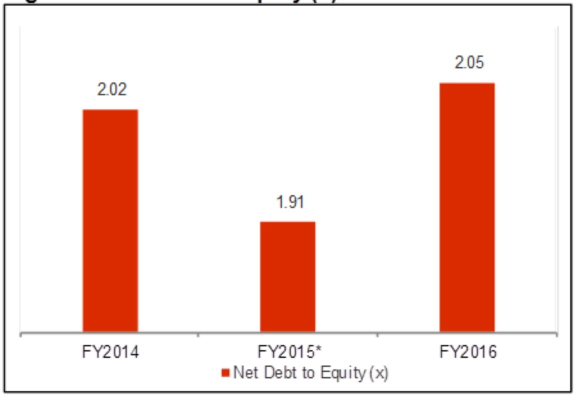
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 30/12/2016	% of debt
Amount repayable in one year or less, or on demand		
Secured	24.1	0.2%
Unsecured	5,959.0	43.6%
	5,983.0	**43.8%**
Amount repayable after a year		
Secured	94.0	0.7%
Unsecured	7,593.6	55.5%
	7,687.6	**56.2%**
Total	**13,670.6**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates