Asia Credit Research

Credit Update: Keppel Corp Ltd ("KEP")

Great to good

- KEP's results continue to be driven by its Property arm although encouragingly, KEP broke even on its Offshore & Marine segment. KEP continues to ramp up its asset management arm and has announced various acquisition plans that would require debt funding.
- While we think there are good reasons for the take-private of KPTT, we are less sure of what future plans KEP and SPH has for M1, given the highly challenging outlook for domestic mobile operators. Per KEP, obtaining majority control would facilitate business transformation of M1, a complex process that can take many years. Assuming the pre-conditions to the deal are satisfied, a voluntary general offer would be launched while Axiata's move is less certain. Assuming all shareholders accept the offer. We think KEP's net gearing may rise, although the exact impact will also depend on merger and accounting consolidation effects (eg: KEP gaining control over M1).
- **Recommendation:** We are **lowering the issuer profile of KEP to Neutral (4)** from Neutral (3) on the back of expectations that its credit metrics will no longer meet Neutral (3) under our Issuer Profile Score ("IPS") scale. In our view, KEP continues to be a defensible credit with strong access to funding markets and its curve should continue to trade at tighter spreads versus other Neutral (4) issuers under our coverage. Within the KEPSP curve, we are underweight the KEPSP 3.1% '20s and prefer the KEPSP 3.725% '23. The KEPSP 3.725% '23s is trading 65bps wider, which more than compensates for its' longer tenor.

Issuer Profile: Neutral (4)

Ticker: **KEPSP**

Background

Listed in 1986, Keppel Corp Ltd ("KEP") is a diversified conglomerate based in Singapore, operating in the real estate, offshore & marine ("O&M"), and infrastructure, logistics, data centres and asset management sectors. KEP is ~20.5%-owned by Temasek Holdings (Private) Ltd.

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Figure 1: KEPSP and Comparable SGD Bonds

Bond	Maturity date/ Reset Date	Net gearing	Ask Yield	Spread
KEPSP 3.1% '20	12/10/2020	0.41x	2.70%	61bps
KEPSP 3.725% '23	30/11/2023	0.41x	3.35%	104bps
KREITS 3.15% '22	11/02/2022	0.39x[1]	3.17%	96bps
SCISP 3.7325% '20	09/04/2020	1.01x	2.77%	75bps
SCISP 2.94% '21	26/11/2021	1.01x	3.11%	92bps
SCISP 3.64% '24	27/05/2024	1.01x	3.74%	140bps

Indicative prices as at 29 October 2018, Source: Bloomberg
Net gearing based on latest available quarter
Aggregate leverage for KREITS as at 30 September 2018

A) Background

Since our last earnings review of KEP dated 3 September 2018, KEP has announced various initiatives including the proposed take-private of Keppel Telecommunications & Transportation Limited ("KPTT") and a joint pre-conditional voluntary general offer for M1 Ltd ("M1"). Reportedly, 18%-owned Keppel Infrastructure Trust is participating in the bid for Ixom, an Australian-based chemical company. While KEP's 3Q2018 credit profile remains defensive, we expect gearing levels at KEP to rise as it takes on debt to fund expansions. Should these come through, KEP's credit metrics would no longer meet our Neutral (3) issuer profile. That being said, we still see KEP as a defensible credit with strong access to funding markets and its curve should continue to trade at tighter spreads versus other Neutral (4) issuers under our coverage.

B) Recent performance and outlook

Still manageable net gearing but rising: Overall revenue for 3Q2018 declined 19.9% y/y to SGD1.3bn on the back of lower revenue recognition from the Property segment (ie: from property trading) and lower revenue from the Investments Division. Offshore & Marine and Infrastructure both saw increase in revenue. Reported operating profit though was only 8.9% lower y/y at SGD270.4mn, driven by the en-bloc sale of a property development project in Beijing and a one-off gain from sale of units from the Keppel DC REIT. KEP reported net profit for the quarter at SGD227.6mn (3Q2017: SGD265.0mn) though foreign exchange translation loss (from the depreciation of RMB against SGD) wiped out much of these profits leading to a total comprehensive income for the period of only SGD2.3mn during the quarter (3Q2018: SGD421.6mn). EBITDA (excluding other operating income and other operating expenses) fell 48.8% to SGD165.4mn, while interest expense was up 11.3% y/y, resulting in lower EBITDA/Interest of 3.2x (3Q2017: 7.0x). It is worth nothing that EBITDA/Interest coverage is only a secondary metric we look at for KEP given its business nature (eg: en-bloc residential sales) which makes this number lumpy. As at 30 September 2018, unadjusted net gearing was 0.41x, slightly above the 0.40x as at 30 June 2018. Secured debt continues to make up only a small proportion of total debt and KEP maintains considerable access to debt markets. We estimate that KEP has up to SGD2.1bn in commitments from the announced proposed purchases and expansion in its asset management business. Assuming all of these are debt-funded, we think net gearing may rise, although the exact impact will also depend on merger and accounting consolidation effects (eg: KEP gaining control over M1). Outside our base case, there is potentially another ~SGD248mn in outlay, should KIT end up buying Ixom and tap unitholders for this purpose.

Property segment continues to drive KEP's income: In 3Q2018, KEP's property revenue declined 67% y/y to SGD181.7mn, despite the higher volume of units sold (we estimate 1,760 units sold in 3Q2018 against 1,320 units in 3Q2017). In 3Q2018, operating profit from the property segment was SGD210.1mn (up 6% y/y) and contributed 72% to KEP's total operating profit. The decline in top line in our view is attributable to the higher proportion of housing units sold in Indonesia and India (34% in 3Q2018 versus 4% in 3Q2017), two markets where per unit sale price is lower. SGD122mn in segmental operating profit for 3Q2018 was attributable to divestment gains from the en-bloc sales of KEP's 51%-stake in Aether Limited, a holding company that indirectly owns a prime commercial site in Chaoyang District, Beijing. Share of associates at the Property segment is attributable to KEP's ~46%-stake in Keppel REIT (Issuer Profile: Neutral (4)). KEP's current landbank translates to ~50,000 units. ~40% of its residential landbank are located in Vietnam, a high-growth housing market where KEP was an early entrant and focusing on the high-end-to-luxury segments. Simplistically, landbank in Vietnam may translate into SGD11.1bn in future revenue, assuming average selling price stays at SGD4,662 per sqm.

Trying to get Offshore & marine ("O&M") to break-even: In 3Q2018, segmental revenue was SGD415.9mn (up 9% y/y) due to higher revenue recognition from projects. Encouragingly, operating profit was SGD6.0mn while net profit (aided by one-off recognition of previously unrecognised interest income) was SGD2.0mn. In contrast, the segment was still loss-making in the previous quarter. KEP continues to focus on reaching break-even for O&M. As at 30 September 2018, net orderbook (excluding the Sete Brasil contracts) was SGD4.4bn, lower than end-June 2018's SGD4.6bn though higher than end-2017's SGD3.9bn. Post quarter-end, KEP won a SGD105mn contract to build two small LNG carriers. While it is too early for us to say that the O&M segment has turned around, we maintain that the outlook looks brighter.

Infrastructure profit driven by one-off gains: The Infrastructure segment reported an 8% y/y increase in revenue to SGD679.9mn, driven by increase in sales in the gas and electricity businesses though partly offset by lower revenue recognition from Keppel Marine East Desalination Plant. Operating profit was SGD42.9mn while net profit was SGD60.0mn in 3Q2018. This was driven by one-off gains from the ~4.1% stake sale of units in Keppel DC REIT in 3Q2018 (SGD20mn impact) and a gain of SGD20mn from change in accounting method of its stake in Keppel REIT. ~18%-owned Keppel Infrastructure Trust ("KIT") recorded a loss after tax of SGD0.4mn though it was cash flow generative taking away depreciation and amortisation which are non-cash. KIT may be looking to buy Ixom, an Australian chemicals company (which is reportedly on the block for more than SGD1.38bn). In our view, if the deal goes through, KIT may need to seek funding from unitholders, including KEP. Common across REITs and business trust, KIT traditionally does not maintain large cash balances. As at 30 September 2018, KIT faces short term debt due of SGD1.0bn against cash balance of SGD226.1mn. With Hyflux Ltd now announcing the introduction of two new Indonesian shareholders, it is no longer actively pursuing a sale of Tuaspring which KEP was reportedly eyeing earlier.

Busy quarter for Asset Management: Asset Management arm Keppel Capital is reported under Investments, alongside 19%-owned M1 Ltd ("M1"), 40%-owned KrisEnergy Ltd and Sino-Singapore Tianjin Eco-City (a G2G project). In 3Q2018, we estimate that the segment only generated SGD20.2mn in net profit (3Q2017: SGD59.9mn). In 3Q2018, KEP had (1)

Entered into a memorandum of understanding with MindChamps on an education real estate fund with an initial asset under management ("AUM") of SGD200mn (2) Announced the ~SGD107mn purchase of 50% in Watermark Retirement Communities (and affiliates) and (3) Announced the joint establishment of a retail real estate assets fund. Per market norms, KEP is expected to hold up to a 10% equity-stake in the proposed fund (~SGD100mn equity injection). Including outstanding capital commitments at the Alpha Data Centre fund, we estimate that KEP would need to fund ~SGD595mn for the asset management segment in the near term as KEP ramps up the business.

Shopping for more: In September 2018, KEP simultaneously announced the proposed take-private of Keppel Telecommunications & Transportation Limited ("KPTT", issuer profile: Neutral (4)) and together with Singapore Press Holdings ("SPH"), the pre-conditional voluntary general offer for M1. KEP already owns a 79.2%-stake in KPTT and we see the take-private deal likelihood as high. At a per share price of SGD1.91, the maximum cash consideration which KEP will pay is SGD226.6mn. While we think there are good reasons for the take-private of KPTT, we are less sure of what future plans KEP and SPH has for M1, given the highly challenging outlook for domestic mobile operators. Per KEP, obtaining majority control would facilitate business transformation of M1, a complex process that can take many years. We infer that KEP and SPH (being the second and third largest shareholders of M1) may have different plans for M1, from those of Axiata Group Berhad ("Axiata"), M1's largest shareholder with a ~28.7%-stake. An earlier strategic review of M1 by the three major shareholders (including the possible sale of M1) fell through by mid-2017. While KEP and SPH intend to gain majority control of M1 (via an offeror entity), it remains to be seen if M1 would be left as a separate listed company. For now, the offeror had only shared its intention to delist, if the free float requirement is unmet. Net-net, the offeror is comfortable keeping M1 listed. In our view, it is unlikely to raise the offer price to achieve a delisting, unless a competing bid emerges.

Axiata's intentions are uncertain though our base case assumes full outlay by KEP for M1: The actual credit impact of the M1 deal is dependent on how much KEP would need to fork out, which in turn is dependent on the proportion of shareholders who accept the deal. We think minority investors are likely to accept the deal, although Axiata's intentions are uncertain. We believe that Axiata would take into account the interest of its shareholders, including its own largest shareholder Khazanah, whose investment/divestment plans are currently indeterminate. Per KEP, the total maximum cash outlay would be SGD1.28bn (assuming all shareholders accept the offer). M1 is unlikely to be a strategic asset for Axiata and its main shareholders. As such, weighing the probabilities, we have used the SGD1.28bn figure for the purposes of this report.

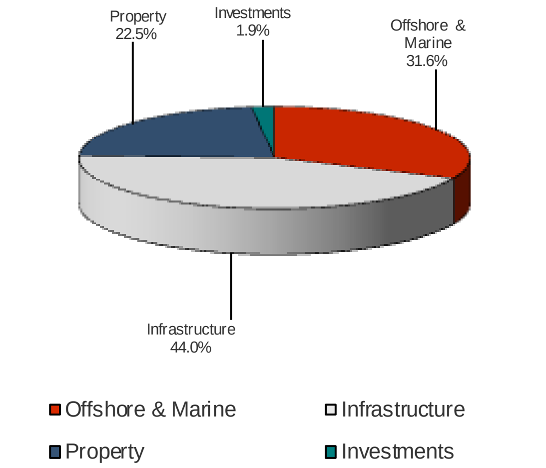
Keppel Corp Ltd

Table 1: Summary Financials

Year End 31st Dec	FY2016	FY2017	9M2018
Income Statement (SGD'mn)			
Revenue	6,767.3	5,963.8	4,288.4
EBITDA	1,407.8	937.7	560.4
EBIT	1,171.3	725.3	427.3
Gross interest expense	224.5	189.2	144.5
Profit Before Tax	1,054.9	515.6	1,034.5
Net profit	821.8	217.2	810.9
Balance Sheet (SGD'mn)			
Cash and bank deposits	2,087.1	2,273.8	2,010.4
Total assets	29,234.2	28,112.8	25,598.7
Gross debt	9,053.0	7,793.0	6,852.2
Short term debt	1835.32	1714.08	589.294
Net debt	6,966.0	5,519.2	4,841.8
Shareholders' equity	12,333.6	11,960.4	11,714.8
Cash Flow (SGD'mn)			
CFO	428.7	1,431.5	199.0
Capex	466.2	393.0	153.8
Acquisitions	463.3	291.4	66.2
Disposals	99.4	838.7	1,229.5
Dividend	621.9	390.1	541.5
Free Cash Flow (FCF)	-37.5	1,038.5	45.2
Key Ratios			
EBITDA margin (%)	20.8	15.7	13.1
Net margin (%)	12.1	3.6	18.9
Gross debt to EBITDA (x)	6.4	8.3	9.2
Net debt to EBITDA (x)	4.9	5.9	6.5
Gross Debt to Equity (x)	0.73	0.65	0.58
Net Debt to Equity (x)	0.56	0.46	0.41
Gross debt/total assets (x)	0.3	0.3	0.3
Net debt/total assets (x)	0.2	0.2	0.2
Cash/current borrowings (x)	1.1	1.3	3.4
EBITDA/Total Interest (x)	6.3	5.0	3.9

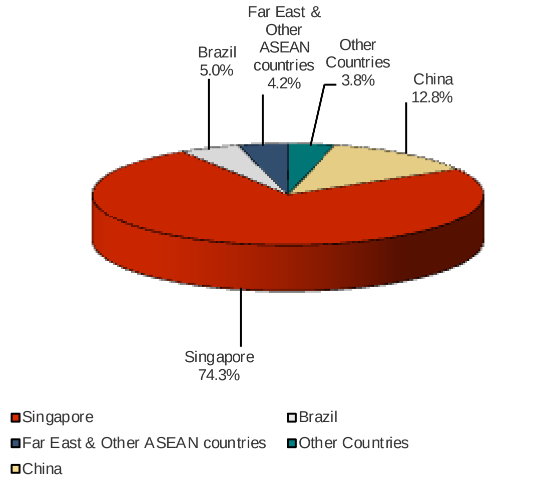
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - 9M2018



Source: Company

Figure 2: Revenue breakdown by Geography - 9M2018



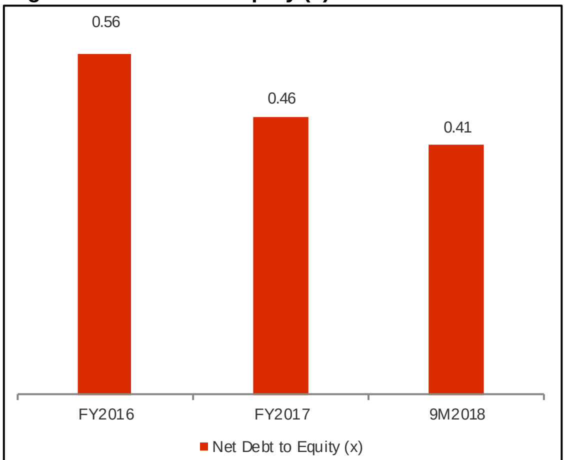
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 30/09/2018	% of debt
.		
Amount repayable in one year or less, or on demand		
Secured	110.8	1.6%
Unsecured	478.5	7.0%
	589.3	**8.6%**
Amount repayable after a year		
Secured	182.5	2.7%
Unsecured	6,080.3	88.7%
	6,262.9	**91.4%**
Total	**6,852.2**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

OCBC Global Treasury	
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Explanation of Issuer Profile Rating ("IPR") / Issuer Profile Score ("IPS")

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings ("IPR") into a 7 point Issuer Profile Score ("IPS") scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold securities in the above-mentioned issuer or company as at the time of the publication of this report.

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