Asia Credit Research

OCBC Bank

Keppel Corporation Ltd: Credit Update

Wednesday, 10 August 2016

More Of The Same

A similar story to 1Q2016: KEP reported 2Q2016 results, with total revenue declining 36.6% y/y to SGD1.6bn. The offshore marine ("O&M") segment continues to be challenged, seeing a 54.4% decline y/y in segment revenue to SGD720.3mn. On a q/q basis, segment revenue was also lower by 11.9%. O&M revenue contribution continues to inch lower and is now just 44% of total revenue (2Q2015: 62%). The segment remains pressured, with the decline in upstream activities reducing demand for drilling assets. Coupled with looming newbuilds from orders made during the boom years, it would be difficult for KEP to win new orders for drilling rigs. This view was also reiterated by management. The tough environment continues to impact KEP's existing order book. New delays by clients over rig deliveries have been made. For example, Grupo R's outstanding order of 3 rigs have been delayed further into 2017 (two of these rigs have already been delayed once in 2015). Segment pre-tax profit continues to slip, falling 60% y/y to SGD88mn. That said, segment operating margin remains robust at 12.8% (2Q2015: 12.3%) for the quarter. Management has continued to cut costs, reducing overheads by ~20% y/y in 1H2016 (including trimming Singapore and overseas direct headcount by 4,900, or 16% of O&M headcount). Management has also indicated that they may consider the temporary closure of some of their yards, should low work volumes require it.

Moving on from Sete Brasil: With Sete Brasil filing for bankruptcy protection, its contract was removed from the O&M order book. In aggregate, the reported order book fell from SGD8.6bn to SGD4.3bn q/q as a result. Two thirds of KEP's order book is now non-drilling related. In fact, of the SGD460mn in new O&M orders won, none were drilling newbuilds. That said, management has indicated that the outstanding Sete Brasil orders, about SGD4bn worth, remain valid and are needed in Brazil (most of Brazil's recent energy discoveries are deepwater assets). Management has also reiterated that the SGD230mn in provisions made in 4Q2015 over the Sete Brasil contract remain adequate. No further disclosures were made regarding the actual amounts owed by Sete Brasil to KEP. We continue to believe that the situation in Brazil will be protracted, given the on-going corruption scandal involving Petrobras' contractors adding to complexity. For the balance of 2016, KEP still has one jackup and two semisubmersibles (of which one is accommodation rather than drilling) to be delivered (to Falcon Energy, SOCAR and Floatel). We believe that it would be unlikely for the O&M segment to recover during 2H2016.

Property remains robust: The property segment saw revenue grow 15.3% y/y to SGD468.7mn, with KEP selling 1200 homes during the quarter (~9% higher relative to 2Q2015) with most of the sales (931 units) derived from China. China continues to be a strong driver for the segment, with KEP generating RMB1.5bn in Chinese sales during 2Q2016 (of which RMB673.1mn worth was derived from Shanghai). KEP still has a China pipeline of 36,292 units for sale (with most of the units in Tianjin and Shenyang). Management indicated that demand in Tianjin is accelerating. KEP, as a JV master developer for Tianjin Eco-City, saw residential land auction prices more than triple to ~RMB8,000 psm of GFA, relative to the beginning of this year. Segment operating margin compressed to 21.7% (2Q2015: 26.6%) but largely held steady q/q. The compression was largely driven by higher contributions from China being

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insufficient to offset softer contributions in Singapore (132 units were sold, mainly from The Glades and Highline Residences). Looking forward, KEP will be recognizing revenue from ~3,400 overseas units sold from 2H2016 till end-2018. In addition, KEP has 18,439 launch-ready homes (of which Singapore consists of 702 units) in the pipeline (to be launch till 2018). As a comparison, KEP sold only 2,450 units in 2014, and 4,570 units in 2015. As a result, we expect contributions from the property segment to help offset weakness at O&M. That said, with the mix of property sales increasingly from overseas, there could potentially be segment margin pressure.

Infrastructure soft, Keppel Capital reorganization complete: The infrastructure segment revenue slumped 25.3% to SGD404mn (~25% of total revenue), due to lower prices and volume from KEP's power and gas business. Segment operating margins were distinctly tighter at 5.7% (2Q2015: 19.5%) due to the absence of divestment gains seen in 2Q2015 (the 51% interest in the Merlimau CoGen plant). The formation of Keppel Capital, consolidating all of KEP's REIT managers as well as Alpha Investment Partners, has been completed. As of end-2Q2016, Keppel Capital had SGD26bn in assets under management. Management has indicated that Keppel Capital would allow KEP to more effectively recycle capital, as well as expand its capital base via co-investments. It is worth noting that two new funds were launched: Alpha Investment Partners' third Asia property fund as well as a new Data Centre Fund, with a target fund size of USD1.5bn (USD410mn already committed). Interestingly, KEP's management has denied any current plans to partially list Keppel Capital.

Stabilization in operating cash flow: KEP generated negative SGD7.2mn in operating cash flow for the quarter, with working capital remaining a drag on cash flow (largely due to O&M). This was however an improvement over the negative SGD354.3mn operating cash flow seen in 1Q2016 and negative SGD555.9mn seen in 2Q2015. Looking forward, with the slowdown in O&M, management indicated there will be less demand on working capital. Capex has fallen as well to SGD62.7mn (2Q2015: SGD157.9mn) for the same reason. As a result, FCF was negative SGD69.9mn. In addition, KEP acquired Cameron's O&M product division, resulting in an outflow of SGD135.5mn. KEP also paid out SGD399.4mn in dividends during the quarter. The cash gap was largely funded by ~SGD700mn increase in net borrowings. It is worth noting that KEP has trimmed its interim dividend from SGD0.12 per share to SGD0.08. Interest coverage remains fair at 7.3x for 1H2016, though it has worsened relative to 10.8x (end-2015). This was driven by the higher interest cost due to additional borrowings. Cash / current borrowings was 1.0x. There are no bond maturities till 2020.

Credit deterioration controlled: Due to higher borrowings, net gearing has worsened from 56% (end-1Q2016) to 62% (end-2Q2016). Net debt / EBITDA has also increased from 3.8x (end-2015) to 5.2x (end-1H2016). With operating cash flow stabilizing and capex needs declining, we believe that KEP would unlikely see sharp deterioration to its credit profile for the rest of 2016 (unless KEP makes sizable acquisitions). This is consistent with our earlier opinion[1] that the worst of KEP's credit profile decline has already been seen in 2015.

Recommendation: We will retain KEP at Neutral Issuer Profile, with the expectation that there will be no large deviations in KEP's credit profile from current levels. With regards to the KEP curve, technical demand has continued to be strong at the front end of the curve, with spreads comparable to pure-play property developers. We believe that the rally was overdone, and are Underweight the KEPSP'20s, KEPSP'22s and KEPSP'23s based on valuation. We are Neutral on the rest of the curve.

[1] OCBC Asia Credit - Keppel Corp - Credit Update - 290116

Keppel Corp

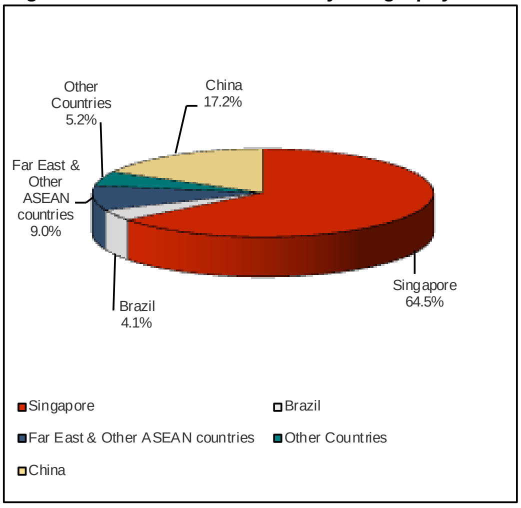
Table 1: Summary Financials

Year End 31st Dec	FY2014	FY2015	1H2016
Income Statement (SGD'mn)			
Revenue	13,283.0	10,296.5	3,368.4
EBITDA	2,305.4	1,673.1	709.9
EBIT	2,040.3	1,426.0	595.6
Gross interest expense	134.0	154.8	96.7
Profit Before Tax	2,888.6	1,997.4	562.6
Net profit	1,884.8	1,524.6	416.3
Balance Sheet (SGD'mn)			
Cash and bank deposits	5,736.0	1,892.8	1,796.8
Total assets	31,590.9	28,920.6	28,476.3
Gross debt	7,382.5	8,258.7	9,131.1
Net debt	1,646.5	6,365.8	7,334.3
Shareholders' equity	14,727.6	11,925.9	11,831.1
Total capitalization	22,110.2	20,184.5	20,962.2
Net capitalization	16,374.2	18,291.7	19,165.4
Cash Flow (SGD'mn)			
Funds from operations (FFO)	2,149.9	1,771.7	530.6
CFO	4.7	-705.0	-361.5
Capex	594.9	1,147.0	113.0
Acquisitions	667.4	581.8	252.1
Disposals	1,728.6	1,504.4	49.1
Dividend	1,028.5	955.7	419.3
Free Cash Flow (FCF)	-590.2	-1,852.0	-474.5
FCF adjusted	-557.6	-1,885.1	-1,096.8
Key Ratios			
EBITDA margin (%)	17.4	16.2	21.1
Net margin (%)	14.2	14.8	12.4
Gross debt to EBITDA (x)	3.2	4.9	6.4
Net debt to EBITDA (x)	0.7	3.8	5.2
Gross Debt to Equity (x)	0.50	0.69	0.77
Net Debt to Equity (x)	0.11	0.53	0.62
Gross debt/total capitalisation (%)	33.4	40.9	43.6
Net debt/net capitalisation (%)	10.1	34.8	38.3
Cash/current borrowings (x)	3.2	2.2	1.0
EBITDA/Total Interest (x)	17.2	10.8	7.3

Source: Company, OCBC estimates

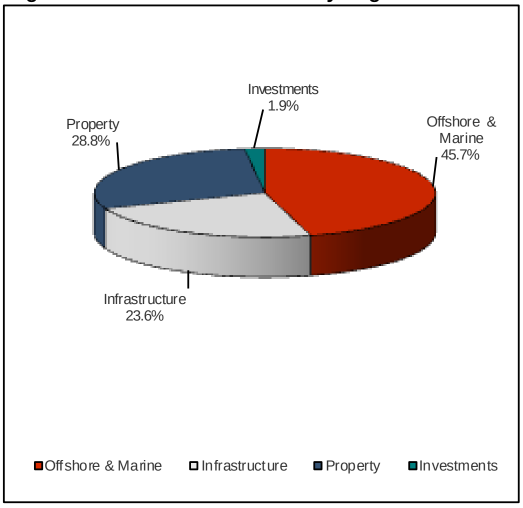
** FCF Adjusted = FCF - Acquisitions - Dividends + Disposals*

Figure 1: Revenue breakdown by Geography - 1H2016



Source: Company

Figure 2: Revenue breakdown by Segment - 1H2016



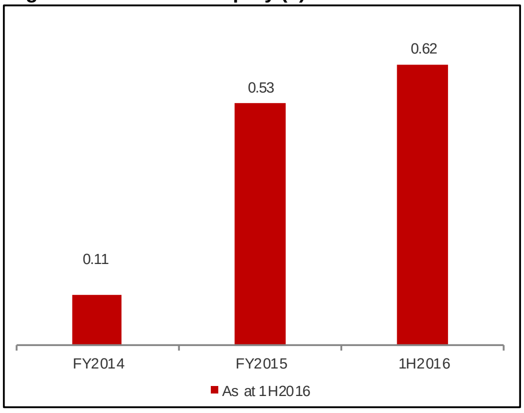
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 31/03/2016	% of debt
Amount repayable in one year or less, or on demand		
Secured	16.7	0.2%
Unsecured	1836.3	20.1%
	1853.0	**20.3%**
Amount repayable after a year		
Secured	1172.8	12.8%
Unsecured	6105.2	66.9%
	7278.0	**79.7%**
Total	**9131.1**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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