Asia Credit Research

OCBC Bank

Keppel Corporation Ltd: Credit Update

Wednesday, 27 April 2016

More Towers, Less Rigs

Segment rotation continues: KEP reported 1Q2016 results, with total revenue declining 38.1% y/y to SGD1.7bn. This was largely driven by the slump in the offshore marine segment, which saw revenue fall 57.6% y/y to SGD817.9mn. Offshore marine ("O&M") is now just 47% of total revenue in 1Q2016, compared to 68% in 1Q2015. In terms of operating profit contribution, it shrunk even further to 40% of total operating profit (1Q2015: 58%). The segment remains pressured with weak energy markets keeping upstream activities in the doldrums. This led to extremely low demand for newbuilds. YTD, KEP only saw ~SGD200mn in new order wins (comparatively, 1Q2015 saw ~SGD500mn in new orders). As a result of the sustained slump in demand, KEP has continued rightsizing their O&M operations, trimming their global workforce a further 9.4%, or 2,800 personnel since the beginning of 2016. One consolation is that KEP was able to improve its segment operating margins to 13.6% (1Q2015: 12.0%) as a result of the cost cutting. Looking forward, we believe that O&M's revenue contribution will continue to fall as KEP's order book continues to shrink.

O&M order book pressures persist: There has been an acceleration of customers seeking to defer their deliveries, with a recent example being Transocean again delaying their jack-up rig deliveries from 2018 – 2020 to 2020. Net contract value for 2016 delivery now stands at just SGD244mn, with gross contract value for 2016 falling from SGD6.8bn (end-2015) to SGD4.0bn (end-1Q2016). Net contract value for 2017 delivery remained steady at ~SGD1.7bn, which could help support O&M revenue for the rest of 2016. As of end-1Q2016, O&M net order book stood at SGD8.6bn, a decline of SGD400mn over end-2015. It should be reminded however that ~USD3bn worth of net order book is the balance Sete Brasil contracts.

Sete Brasil edging towards bankruptcy: On 20/04/16, it was reported by Reuters[1] that Sete Brasil's shareholders have voted to allow Sete Brasil to seek bankruptcy protection. This looks to be driven by the breakdown in negotiations between Sete Brasil and its sole customer, Petrobras, with regards to restructuring their existing lease agreement. KEP has already taken SGD230mn in provisions during 4Q2015 for its Sete Brasil exposure, and management has iterated that they believe the provisions to be adequate. KEP has also stated that they have stopped work on the Sete Brasil contract by the end of 2015. In our view, the restructuring of Sete Brasil could potentially be a protracted affair, potentially spanning several quarters, if not years. That said, as per our previous update on KEP[2], we believe that the stress on KEP's balance sheet would be controlled should Sete Brasil file for bankruptcy. Management has also indicated that there is currently no need to take additional provisions over the other O&M contracts.

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[1] http://www.reuters.com/article/us-brazil-corruption-petrobras-sete-bras-idUSKCN0XH2QP
[2] OCBC Asia Credit - Keppel Corp - Credit Update - 290116

Property segment the clutch: Segment revenue grew 66.0% y/y to SGD503.0mn. KEP sold 940 homes during the quarter (~31% higher relative to 1Q2015). About 62% of segment revenue was generated overseas. China continues to be a strong driver for the segment, with KEP generating RMB1.1bn in China sales during 1Q2016. KEP still has a China pipeline of 37,375 units for sale (with ~25% launch ready). China also contributed a sizable amount of profits for the quarter (SGD67.4mn in aggregate). Looking forward though, performance out of China may be more muted as the landbank exposure to 1st tier cities is relatively small. Operating margin for the segment kept steady at 22.0% (1Q2015: 22.8%). The infrastructure segment revenue (22% of total revenue) slumped 22.9% y/y, due to lower prices and volume from KEP's power and gas business. Operating margins for the segment remained weak at just 3.9%.

Operating cash flow swung back to negative: KEP generated negative SGD354.3mn in operating cash flow for the quarter (1Q2015: SGD284.3mn, 4Q2015: SGD33.4mn). This was mainly driven by SGD512.5mn being paid to trade creditors (working capital needs for O&M and property). Though capex was controlled at SGD50.3mn (2015: SGD1.1bn), FCF was negative ~SGD405mn. Management did point out that they will continue to be disciplined with capex spending going forward, particularly for the O&M segment (1Q2016 segment capex was ~SGD14mn). The cash gap was funded by SGD172.3mn in net borrowings as well as by drawing on cash on its balance sheet. Due to the lower EBITDA generated, interest coverage weakened as well to 8.2x (2015: 10.2x), though it remains fair. Cash / current borrowings stood at 1.4x, with no bond maturities till 2020. As such, we believe that KEP's liquidity profile is good.

Credit deterioration within expectations: Due to the increase in borrowings as well as use of cash to fund the cash gap, net gearing has worsened slightly from 53% (end-2015) to 56% (end-1Q2016). Net debt / EBITDA has worsened as well to 4.4x (2015: 3.8x) due to both slightly higher borrowings and weaker EBITDA. This was still within our expectations[3] as we believed that the worst of the deterioration to KEP's credit profile has already occurred in 2015. Management has also indicated that they seek "to maintain an institutional quality balance sheet" with a net gearing of less than 100%. One area to monitor would be the potential acquisition of BIFFA.

Recommendation: Though the O&M segment will continue to be a drag on overall performance, we continue to believe that credit profile deterioration will be muted going forward. At the same time, we do not believe that KEP will be able to meaningfully improve its credit profile in the near term due to the challenging environment. We will hold KEP at <u>Neutral Issuer Profile.</u> The KEP curve has rallied strongly since selling off at the beginning of the year:

	28/01/16 prices				**Current prices**		
	Bid	Ask	Mid Spread		Bid	Ask	Mid Spread
KEPSP'20	98.65	99.15	105bps		100.0	101.0	94bps
KEPSP'22	96.0	98.0	125bps		98.5	99.5	116bps
KEPSP'23	97.0	99.0	144bps		99.75	100.2	138bps
KEPSP'27	93.0	96.0	177bps		100.25	101.50	144bps
KEPSP'42	85.5	90.0	182bps		96.0	98.0	137bps

*Indicative prices as of 27/04/16

We believe that it would make sense for investors to take some profit, particularly on the long end of the curve (the KEPSP'42s). We also believe that the KEPSP'20s look rich on an RV basis when you can get comparable yields for SUNSP'20s with a slightly shorter tenure. With this in mind, for our bond recommendations, we are Underweight on the KEPSP'20s and KEPSP'42s, while keeping the rest of the curve at Neutral.

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

Keppel Corporation Ltd

Table 1: Summary financials

Year ended 31st December	FY2014	FY2015	1Q2016
Income statement (SGD' mn)			
Revenue	13,283.0	10,296.5	1,743.0
EBITDA	2,305.4	1,673.1	382.6
EBIT	2,040.3	1,426.0	326.1
Gross interest expense	134.0	154.8	46.6
Profit Before Tax	2,888.6	1,997.4	278.2
Net profit	1,884.8	1,524.6	210.6
Balance Sheet (SGD'mn)			
Cash and bank deposits	5,736.0	1,892.8	1,636.3
Total assets	31,554.8	28,932.1	28,378.2
Gross debt	7,382.5	8,258.7	8,548.1
Net debt	1,646.5	6,365.8	6,911.8
Shareholders' equity	14,727.6	11,925.9	12,097.0
Total capitalization	22,110.2	20,184.5	20,645.1
Net capitalization	16,374.2	18,291.7	19,008.8
Cash Flow (SGD'mn)			
Funds from operations (FFO)	2,149.9	1,771.7	267.1
CFO	4.7	-705.0	-354.3
Capex	594.9	1,147.0	50.3
Acquisitions	667.4	581.8	75.5
Disposals	1,728.6	1,504.4	6.9
Dividends	1,028.5	955.7	10.2
Free Cash Flow (FCF)	-590.2	-1,852.0	-404.6
Adjusted FCF*	-557.6	-1,885.1	-483.4
Key Ratios			
EBITDA margin (%)	17.4	16.2	22.0
Net margin (%)	14.2	14.8	12.1
Gross debt/EBITDA (x)	3.2	4.9	5.5
Net debt/EBITDA (x)	0.7	3.8	4.4
Gross debt/equity (x)	0.50	0.69	0.70
Net debt/equity (x)	0.11	0.53	0.56
Gross debt/total capitalization (%)	33.4	40.9	41.1
Net debt/net capitalization (%)	10.1	34.8	36.0
Cash/current borrowings (x)	3.2	1.1	1.4
EBITDA/gross interest (x)	17.2	10.8	8.2

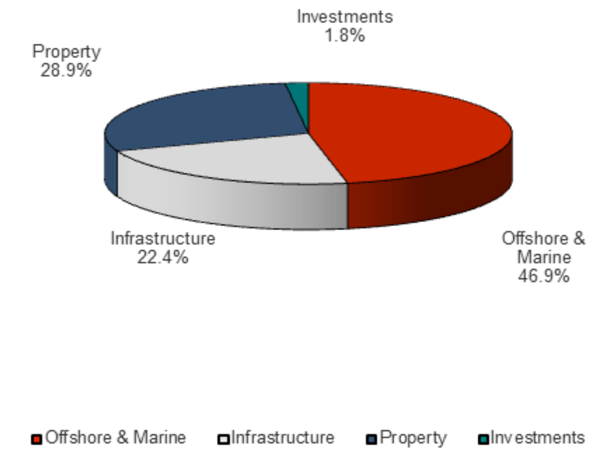
Source: Company, OCBC estimates
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

Figure 3: Debt maturity profile

Amounts in SGD mn	As at 31/03/2016	% of debt
Amount repayable		
One year or less, or on demand		
Secured	17.8	0.2%
Unsecured	1116.8	13.2%
After one year		
Secured	1236.2	14.6%
Unsecured	6072.6	71.9%
Total	**8443.4**	**100.0%**

Source: Company

Figure 1: Revenue breakdown by operations – 1Q2016



Source: Company

Figure 2: Revenue breakdown by geography – 1Q2016

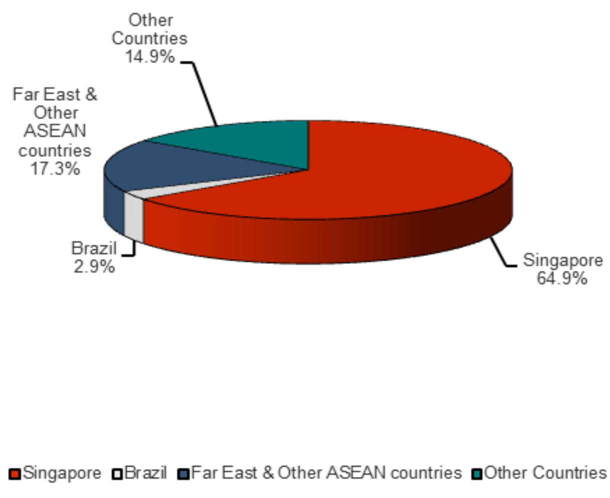
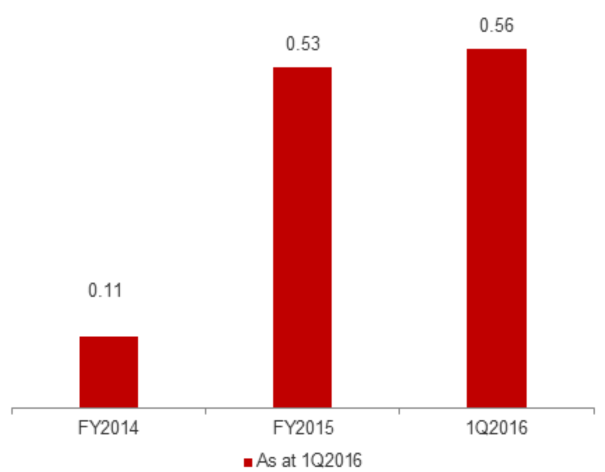


Figure 4: Net Debt to Equity (x)



Source: Company