Asia Credit Research

OCBC Bank

Sembcorp Industries Ltd: Credit Update

Wednesday, 24 February 2016

Uncertainties Persist

- Though the utilities segment was unable to fully mitigate the deterioration in O&M performance, we expect non-domestic utilities to provide more support going forward. Divestment gains in utilities helped offset O&M provisions.
- Though SCI / SMM were more badly hit by Sete Brasil relative to KEP, SMM has the larger order backlog. We expect O&M weakness to persist through 2016, with downside risk from further client stress.
- 2015 could potentially be the worst period of credit deterioration as looking forward cash needs will be more muted. SCI's large balance sheet also provides some buffer to absorb more O&M pressures. Retain Issuer Profile at **Neutral**.

- **O&M pain continues**: As mentioned in our recent KEP credit update[1], SCI's offshore marine ("O&M") segment (effectively SMM) has been pressured by its exposure to Sete Brasil. Aside from Sete Brasil, SMM also faced a contract dispute with Marco Polo Marine ("MPM"), which resulted in a jack-up rig order cancellation, as well as delivery uncertainty due to client stress (specifically the West Rigel semi-sub drilling rig ordered by North Atlantic Drilling). As a result of the various issues facing SMM, SMM took SGD609mn in impairment charges and provisions for 2015, of which SGD329mn were attributed to the Sete Brasil contract for drillships. In addition, SMM also had SGD192mn share of losses from its holdings in COSCO Shipyard (30% owned by SMM). COSCO Shipyard focuses on ship repair, ship building and marine engineering. It generated losses due to the weak environment and inventory write-downs. _ These losses have impacted SCI's aggregate results.

- **Still early for utilities to provide sufficient support**: For 2015, SCI reported SGD9.5bn in total revenue, down 12.4% y/y. Both its utilities and O&M business saw revenue declines (of 12.8% and 14.8% respectively). For 4Q2015, utility revenue fell 15.9% y/y while O&M revenue fell 8.2% y/y. Utilities segment revenue was down mainly due to weakness in the domestic power generation business. Performance was weak due to lower HSFO prices. Though the ramping up of TPCIL's power plant operations in India (full commercial operations in September 2015) helped mitigate segment performance, TPCIL was affected by the flooding in Chennai, which caused the plant to halt operations for a couple of weeks. Looking forward though, with TPCIL fully operational in 2016, the business should be supportive of the utilities segment going forward. Low HSFO prices and the oversupply in capacity are likely to continue to pressure the domestic power business in the near term, but we expect SCI's overseas growth strategy (plants in Myanmar, Bangladesh, China and India) to increasingly contribute to the segment.

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

- **Externalities to dominate O&M performance**: For the O&M business, revenue declined during the quarter largely to lower rig building revenues recognized due to client deferments and delays, as well as due to revenue reversal (likely on the MPM jack-up rig cancellation). Given current weak energy markets, we believe that the O&M segment will continue to be pressured, with upstream players deferring exploration and development spending, which in turn hurts the market for oil & gas equipment and service providers. Risks include further client stress leading to more order deferrals or cancellations. Competition amongst rig builders would likely escalate, with players aggressively capturing orders that still exist, potentially at lower contract prices leading to margin pressure. SMM is attempting to mitigate this by focusing on non-drilling related contracts, such as the order win for the semi-sub construction crane. With the expansion of the Tuas shipyard, new business opportunities, such as repair work on larger vessels will also be available. That said it is unlikely that SMM will be able to replace the lost newbuild drilling asset revenues, as such we expect O&M revenue to remain pressured through 2016.

- **Divestment gains mitigated losses**: For 2015, net profit fell 31.5% y/y to SGD548.9mn. This was largely driven by the O&M segment, flipping from a net profit of SGD340.0mn in 2014 to a loss of SGD176.4mn in 2015. As mentioned earlier, the O&M losses were largely generated by the SGD609mn in provisions as well as SGD192mn share of losses from COSCO Shipyard. The sharp increase in utilities segment net profit, up 72.0% y/y to SGD701.5mn, helped to partially offset the losses generated from the O&M segment. These were largely non-recurring divestment gains though, such as the SGD353.2mn gain recognized upon the divestment of SembSita in 4Q2015. Excluding divestment gains and impairments though, the utilities segment would have generated SGD331.6mn in profits, down 18.7% y/y. This was largely driven by lower spark spreads pressuring the domestic power business. Though we don't expect the overcapacity situation in the Singapore generation market to improve in the near-term, one solace is that utilities net profit from overseas is now ~60% of segment profit for 2015, compared to ~41% in 2011.

- **O&M order book robustness**: One commendable area would be SMM winning SGD3.2bn in additional O&M orders (all non-drilling related) during 2015, despite the challenging environment. The order wins include USD1bn contract to construct three topsides for Maersk Oil as well as USD1bn contract to build the world's largest semi-sub crane vessel for Heerema Offshore. Comparatively, KEP was able to win SGD1.8bn in new O&M orders for 2015. In aggregate, SMM was able to end 2015 with SGD10.4bn in O&M order book. It should be noted however, like KEP, a sizable part of the order book is attributed to Sete Brasil. Sete Brasil's challenges have been well-documented. Should the seven drillships under that contract get cancelled, the decline in existing orderbook has been reported by Reuters (quoting SMM's CEO[2]) to be SGD3.2bn. This would reduce the O&M order book to SGD7.2bn. Though net order book is likely to continue to decline, it does provide some revenue support for the O&M segment for the next couple of years.

- **Uncertainties in Brazil**: SCI / SMM does not disclose the amount of revenue generated from the Sete Brasil contracts, nor do they provide the profits recognized to date based on work done, as the company views the information to be commercially sensitive. As such, we had to generate estimates based on information disclosed. As of the end of 2014, SMM had SGD6062mn worth of drillship orders. This includes ~SGD1360mn in new orders for two drillships for Transocean. As such, the balance ~SGD4.7bn is estimated to be unexecuted Sete Brasil contract outstanding as of end-2014. Subsequently, it was reported that ~SGD3.2bn in order book would be impacted if the Sete Brasil contract gets cancelled. These two numbers imply that ~SGD1.5bn worth of Sete Brasil

[2] http://www.reuters.com/article/sembcorp-marine-brazil-idUSL3N15U2OT

contract was executed through 2015 (though not necessarily all work done was recognized as revenue). Another way to get an indication would be the work-in-progress on the drillships. As of end-2014, three drillships were 30%, 70% and 80% completed. As of end-1H2015, four drillships were 30%, 60%, 74% and 80% completed, for a total change of 64% of one drillship equivalent during 1H2015. The original contract price for each drillship was ~USD800mn. As such, the work done during 1H2015 was roughly ~SGD720mn. As of end-2015, drillship completion was indicated to be in the range of 50% – 90%. In aggregate, the estimated amount of Sete Brasil work done in 2015 is between ~SGD700mn and ~SGD1500mn (though revenue recognized is likely to be distinctly lower). Currently, SMM has taken about SGD329mn in provisions relating to Sete Brasil.

- **Liquidity considerations**: During 2015, SCI generated negative SGD1.1bn in operating cash flow (including interest expense). This was largely driven by ~SGD2bn in cash used for inventory and work-in-progress for the O&M business. SCI also spent SGD1.4bn in capex (1/3 in utilities, 2/3 in O&M), as well as SGD640mn in investments in subsidiaries, associates and JVs. In addition, SCI paid out SGD440mn in dividends / perpetual securities distributions during the year. The ~SGD3.5bn in cash usage was largely funded by the SGD2.1bn increase in gross borrowings during 2015. The balance was funded by ~SGD700mn in divestments as well as ~SGD600mn in new perpetual securities. Using management's adjusted EBITDA (2014: SGD1457mn, 2015: SGD1720mn), interest coverage has worsened from 20.8x (2014) to 7.2x (2015) due to the sharp increase in interest expense. Cash / current borrowings worsened as well from 1.5x (2014) to 0.9x (2015). It is worth noting that SCI has no near-term bond maturities. Looking forward, we expect capex needs to decline as the Brazilian shipyard and Tuas expansion work is largely done. Working capital needs are also likely to decrease given the slower pace of work done at O&M. These factors may improve SCI's liquidity situation, particularly with more steady income contribution from the utility side as certain projects ramp up. We will observe 1H2016's cash usage to ascertain if SCI would need additional liquidity (as cash balances have remained largely unchanged y/y), though it would seem that any additional capital required would be at SMM rather than SCI based on the past two years cash burn.

- **Credit profile impact**: As of end-2015, SCI's credit profile deteriorated, with net gearing increasing from 44% (end-2014) to 64% (end-2015). This was largely driven by the increase borrowings by SGD2.1bn y/y to SGD6.8bn, as mentioned earlier. The perpetual securities issuance during the year helped mitigate the impact of the increase in borrowings. Despite the challenging 4Q2015 results, on a quarterly basis the deterioration was relatively controlled, with net gearing increasing from 55% (end-3Q2015) to 64% (end-4Q2015). This was driven by asset divestment gains helping to offset the provisions taken (mitigating the impact on equity), as well as divestment proceeds helping to offset cash needs, hence reducing the total amount of borrowings required for the quarter. Looking forward, we believe that SCI's credit profile will continue to face pressure due to the issues facing O&M, but is unlikely to see sharp deterioration due to its diversified businesses.

- **Recommendation**: Though SCI / SMM seemed to have been more impacted by Sete Brasil as its work on the drillships were further along compared to KEP's semi submersibles. In aggregate though, due to SCI's large balance sheet, improving non-domestic utilities business and tapering cash needs, we believe that further deterioration to SCI's leverage profile in 2016 would be more muted relative to 2014 and 2015. As such, we are comfortable retaining our Issuer Profile at **Neutral**.

  Post KEP's 2015 results released during the third week of January 2016, both KEP and SCI's curves have largely seen some recovery through the month of February for the more liquid bonds, as investors had the time to digest the details.

	01/02/16 prices				**23/02/16 prices**		
	Bid	Ask	Mid Spread		**Bid**	**Ask**	**Mid Spread**
SCISP'20	98	101	194bps		**98.9**	**99.9**	**173bps**
SCISP'24	97	99	175bps		**97**	**99**	**176bps**
SCISP'26	92	94	173bps		**94.1**	**96.1**	**148bps**
SCISP 4.75'49	91	94.25	456bps		**96.75**	**97.50**	**337bps**
SCISP 5'49	95.5	98.5	410bps		**98.25**	**99.5**	**351bps**

Indicative prices as of 23/02/16. For the perps its spread to call.

Based on the standalone SCI curve, it would seem as if the longer dated bonds have rallied more strongly compared to the shorter dated bonds. As such, we prefer the SCISP'20s over the other two straight bonds mentioned. However, in general, given the rally, we believe that the three bonds are close to fair value (with the SCISP'26 potentially on the rich side). As such, we will retain our Neutral bond recommendations on the SCISP'20s, SCISP'24s and SCISP'26s. As a comparison, the KEP curve seemed to have rallied even more strongly, with the KEPSP'20s trading ~60bps tighter compared to the SCISP'20s.

As for the perpetual securities, we originally had the SCISP 4.75'49s at Overweight as it sold off through January. Since then however, the bonds have rallied sharply and are now trading close to the SCISP 5'49s. As such, we will downgrade its bond recommendation and hold both perpetual securities at Neutral.

Sembcorp Industries Ltd

Table 1: Summary financials

Year ended 31st December	FY2013	FY2014	FY2015
Income statement (SGD' mn)			
Revenue	10,797.6	10,894.7	9,544.6
EBITDA	1,251.5	1,377.0	612.2
EBIT	948.2	1,062.2	207.3
Gross interest expense	117.9	70.1	238.0
Profit Before Tax	1,214.4	1,246.4	426.3
Net profit	820.4	801.1	548.9
Balance Sheet (SGD'mn)			
Cash and bank deposits	2,255.9	1,661.4	1,606.5
Total assets	13,753.9	17,176.4	19,915.5
Gross debt	1,955.8	4,841.1	6,832.9
Net debt	-300.1	3,179.6	5,226.5
Shareholders' equity	6,530.0	7,232.3	8,043.5
Total capitalization	8,485.8	12,073.3	14,876.4
Net capitalization	6,229.9	10,411.9	13,270.0
Cash Flow (SGD'mn)			
Funds from operations (FFO)	1,123.7	1,115.9	953.8
CFO	1,402.9	-119.8	-1,061.8
Capex	1,198.0	1,337.8	1,392.8
Acquisitions	290.8	267.6	640.6
Disposals	41.3	23.4	704.8
Dividends	412.6	549.1	439.6
Free Cash Flow (FCF)	204.9	-1,457.7	-2,454.5
Adjusted FCF*	-457.1	-2,251.0	-2,829.9
Key Ratios			
EBITDA margin (%)	11.6	12.6	6.4
Net margin (%)	7.6	7.4	5.8
Gross debt/EBITDA (x)	1.6	3.5	11.2
Net debt/EBITDA (x)	-0.2	2.3	8.5
Gross debt/equity (x)	0.30	0.67	0.85
Net debt/equity (x)	-0.05	0.44	0.65
Gross debt/total capitalization (%)	23.0	40.1	45.9
Net debt/net capitalization (%)	-4.8	30.5	39.4
Cash/current borrowings (x)	5.4	1.5	0.9
EBITDA/gross interest (x)	10.6	19.6	2.6

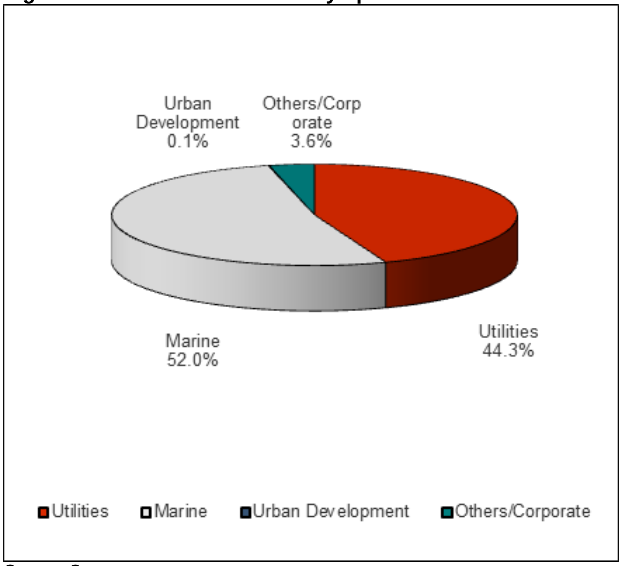
Source: Company, OCBC estimates
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

Figure 3: Debt maturity profile

Amounts in SGD mn	As at 31/12/2015	% of debt
Amount repayable		
One year or less, or on demand		
Secured	794.4	11.6%
Unsecured	1006.2	14.7%
After one year		
Secured	1462.4	21.4%
Unsecured	3570.0	52.2%
Total	**6832.9**	**100.0%**

Source: Company

Figure 1: Revenue breakdown by operations – FY2015



Source: Company

Figure 2: Revenue breakdown by geography – FY2015

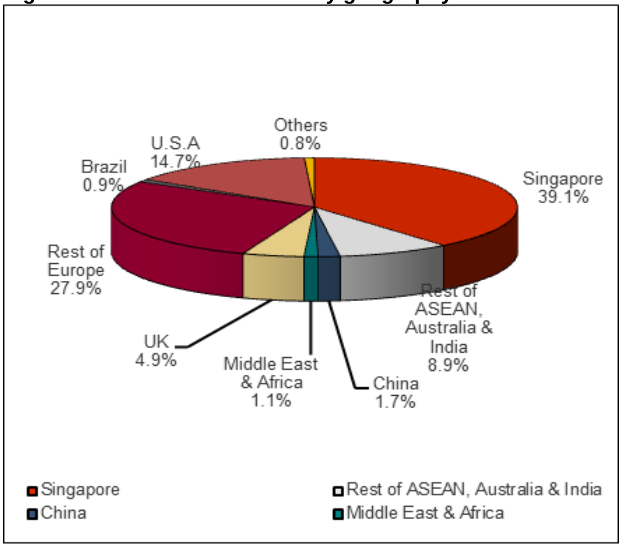
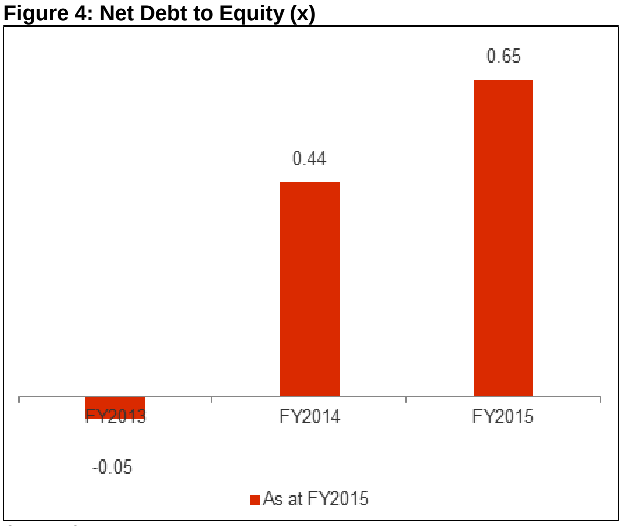


Figure 4: Net Debt to Equity (x)



Source: Company