Asia Credit Research

CMA CGM (Parent of Neptune Orient Lines): Credit Update

Friday, 30 November 2018

A Shipper's move into Logistics

- **CMA CGM pre-announced a Public Tender Offer for CEVA Logistics AG ("CEVA"). Shareholders of CEVA have the option to either remain invested in CEVA or exit at a value of CHF30.00 per share in cash.**
- **At present, CMA CGM owns a non-controlling 33%-stake of CEVA's capital. A combination of the two is likely to bring about cost, revenue and operational synergies, at the expense of higher debt at CMA CGM in order to finance the acquisition of additional CEVA shares.**
- **Although details still need to be panned out and the Public Tender Offer is subject to CEVA's shareholders' option as well as regulatory requirements, the likelihood of the deal happening is high in our view.**
- **Recommendation:** We are maintaining a Neutral (4) issuer profile on CMA CGM for now as we await further details. Should the acquisition cost be ~USD1bn (assuming CMA CGM buys over all the remaining stake it does not already own in CEVA) and this is fully funded by debt, we think the transaction will put pressure on CMA CGM's Neutral (4) issuer profile.

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Background

Following CMA CGM's acquisition of NOL in mid-June 2016, financial results of NOL has been limited. As such, we had assumed coverage of CMA CGM given NOL has been delisted from the SGX. We use the performance of CMA CGM (the parent) as a proxy for NOL's performance. While CMA CGM has not provided a corporate guarantee for NOL's existing bonds, NOL is likely to receive support as a material operating subsidiary. We are Neutral the NOLSP 4.65% '20s and NOLSP 4.4% '21s.

Recent Developments

On 26 November 2018, CMA CGM made a pre-announcement of a Public Tender Offer for CEVA at CHF30.00 per share which corresponds to a ~46% premium with respect to the Volume Weighted Average Price ("VWAP") of CEVA over the 60 trading days prior to 1 October 2018. This came after its first expression of intent on 25 October 2018 through their new relationship agreement to reinforce the industrial cooperation between the two companies. The Public Tender Offer process is expected to close in April 2019 and CEVA will remain a listed company with a significant free float and an arm's length business relationship with CMA CGM. At present, CMA CGM owns a non-controlling 33%-stake of CEVA's capital as well as two seats on CEVA's Board of Directors, on top of a working relationship to develop joint commercial offerings. Prior to acquiring additional shares which increased its stake by 7.88% to 32.87% on 17 October 2018, CMA CGM's initial investment in CEVA represented 24.99% of CEVA's capital and amounted to CHF379mn (USD381mn) at the price of CHF27.50 per share.

CMA CGM is a privately held company incorporated and headquartered in France. It is the third largest container shipping company operating primarily in the international containerised transportation of goods, container terminal operations and freight forwarding. CMA CGM has total assets of USD20.38bn where vessels alone make up ~43%. CEVA is a Switzerland non-asset based supply chain management company listed on the SIX Swiss Exchange with a market cap of CHF1.64bn (~USD1.64bn) as at 30 November 2018. CEVA designs, implements and operates end-to-end freight management and contract logistics solutions for multinational and small and medium sized companies on a local, regional and global level. Nicolas Sartini, previously the CEO of APL since CMA CGM's takeover of APL in June 2016, has been appointed as COO and Deputy CEO of CEVA as of 1 January 2019.

Aside from the abovementioned, CEVA has agreed to acquire CMA CGM's freight management activities – CMA CGM Log ("CCLog") for USD105mn in cash though subject to regulatory approvals, confirmatory due diligence and legally required consultation processes. CCLog has a significant presence in high growth markets including India, China, Australia and the US. The transaction is expected to close in 2Q2019, following the completion for the Public Tender Offer by CMA CGM for CEVA.

Credit Considerations for CMA CGM

- **Downside risks in sight:** In light of the new International Maritime Organisation ("IMO") Low Sulphur Regulation of 0.5% global sulphur cap on fuel content which will be effective from 1 January 2020 to reduce the environment impact of the industry, CMA CGM will use 0.5% fuel oil for its fleet, LNG to power some of its future container ships (9 ships on order) and order several scrubbers (exhaust gas cleaning systems) for its ships. CMA CGM shared that all these measures represent an estimated major additional cost of ~USD160 per Twenty-foot Equivalent Units ("TEU"). While this regulation may accelerate the scrapping of old vessels that are less fuel efficient, thereby reduce supply and allowing larger players an opportunity to gain pricing power, we see this on balance as negative given higher costs are certain while lower vessel supply is an expectation. In addition, we also see further downside risks stemming from the rise in protectionism and trade tension. This is expected to weigh on global trade and possibly negatively impact the top line figures at shipping companies.

- **Continued improvement in top line:** CMA CGM's revenue increased 6.3% y/y to SGD6.06bn in 3Q2018 on the back of greater volume (+5.6% y/y) traded particularly in the Transpacific, India/Oceania and Africa lines. Revenue per container transported was also higher y/y by 0.8% unlike 2Q2018 which saw a decline of 2.1% y/y. Although operating expenses continued to surge due to higher bunker fuel prices, the pace appeared to have slowed (3Q2018: +13.6% y/y, 2Q2018: +16.9% y/y, 1Q2018: +22.5% y/y). The introduction of an Emergency Bunker Surcharge did partially offset the higher price of fuel. Consequentially, reported core EBIT (excluding asset sales, depreciation and non-recurring items) plunged 57.6% y/y to USD241.1mn. That being said, reported core EBIT margin improved to 4.0% as compared to 1.2% in the preceding quarter due to the stronger top line figure. Net profit, though 238.1% higher q/q at USD110.9mn, was down 64.9% y/y. Fleet capacity also rose 7.6% y/y to 2.69mn TEU. While we expect the top line improvements to keep pace, the abovementioned downside risks will keep CMA CGM on its toes.

- **Acquisition of Containerships, in line with strategy:** On 31 October 2018, CMA CGM completed the takeover of Containerships, a Finnish container-transportation and logistics company that specialises in the intra-European market and has a reported revenue for year ended 31 December 2017 of EUR266.7mn. This is in line with CMA CGM's strategy to further deepen its regional networks as Containerships will complement CMA CGM's affiliate MacAndrews' (acquired in 2002) service offering in North Europe and the Mediterranean. Given that Containerships will take delivery of four LNG-fuelled vessels by January 2019, this should help CMA CGM comply with the IMO 2020 regulation. In addition, CMA CGM has also acquired an additional 7.88% stake in CEVA leading to an aggregate stake of 32.87% on 17 October 2018. With this transaction, CMA CGM expanded its presence in the logistics sector, which is closely related to shipping.

- **Leverage may inch even higher:** In 3Q2018, net gearing edged higher to 134% (2Q2018: 129%) largely due to lower cash. Leverage could rise further with CMA CGM resuming its capacity expansion, with the order of nine 22,000 TEU vessels made last year (deliveries to commence in 2020). Furthermore, we think CMA CGM will have to seek external financing to fund its Public Tender Offer for CEVA which is expected to conclude in April 2019. These transactions are likely to push leverage higher.

Credit Considerations for CEVA

- **Diversified revenue sources:** CEVA reported a 1.57% y/y increase in revenue in 3Q2018 to USD1.8bn with freight management ("FM") (e.g. air, ocean, ground pickup and delivery) revenue up 4.9% y/y and contract logistics ("CL") (e.g. inbound logistics, outbound/distribution logistics) revenue down 1.2% y/y. Both businesses account for ~50% of revenue each (FM: 48.6%, CL: 51.4%). 9M2018 EBITDA margin (before specific items and share based compensation cost) is 2.5% for FM and 2.9% for CL. EBITDA margin for FM is stable. However the same cannot be said of CL which saw EBITDA margin of just 0.8% in 3Q2018 due to issues (including change of business scope and higher operating costs) of two contracts and a local partner company – Cooperativa went bankrupt in Italy. Revenue of FM can be somewhat evenly broken down further into Air (42.5% of FM revenue), Ocean (30.8%) and Others (26.8%). Revenue is also diversified geographically with Americas contributing 33.7% of total revenue, Asia Pacific at 27.0% and Europe at 39.3%. As such, we think CEVA is substantially diversified.

- **Minimal refinancing risk in the short term:** On 3 August 2018, CEVA completed a comprehensive refinancing with the issuance of EUR300mn 5.25% '25s and took up USD475mn term loan due 2025 and USD585mn credit facility due 2023. These proceeds were used to repay and redeem USD438mn 9.0% PIK notes due 2020, term loans due 2021 and drawings under a credit facility due 2021. As a result, CEVA has no maturing debt in 2019. We see USD393mn of debt maturing in 2020. In addition, the weighted average period maturity of the borrowings was also lengthened substantially to 5.1 years from 2.3 years as at 30 June 2018. The average floating interest rate was 1.7% and 5.2% for EUR and USD denominated loans respectively post-refinancing, significantly lower from the 9M2018 average of 3.5% and 5.8% observed.

- **Upside from strategic partnership with CMA CGM:** CEVA has plans to acquire CCLog from CMA CGM, which has extended a Public Tender Offer to CEVA's shareholders, for USD105mn to be paid in cash. Given CEVA has USD368mn cash on hand as at 30 September 2018, we think CEVA is able to fulfil the transaction without incurring additional debt. Having said that, we note that CEVA has up to USD184mn undrawn facilities which it has the option of utilising. Closing of the CCLog acquisition is expected in 2Q2019. Management expects the integration of CCLog into CEVA's FM business to reinforce CEVA's footprint in Ocean FM with 170,000 additional controlled TEUs and reap significant cost synergies. Further estimation of CCLog to generate revenue of USD630mn and EBITDA of USD16mn was provided. Revenue and EBITDA of CEVA in 3Q2018 was USD1810mn and USD15mn respectively.

- **Exposed to trade tension:** At present, US-China trade for CEVA represents 14% of Air and Ocean revenues. Management estimated that the contemplated tariff increase on USD200bn of goods is unlikely to affect more than 13% of CEVA's business in the US-China trade lane, driven in particular by Consumer and Retail business segments. However, internal consumption in China is no doubt affected. CEVA has expressed the possibility of switching procurement from China to alternative countries in Southeast Asia (e.g. Vietnam, Cambodia, Myanmar, and Thailand).

Business Considerations for CMA CGM and CEVA

- **Cost synergies:** Combining CCLog with CEVA's freight management business will strengthen CEVA's footprint in the Ocean Freight Management and create economies of scale from a broader customer base. CEVA will most likely benefit from CMA CGM's managerial and operational expertise and jointly boost the operating efficiency for both companies. Given CMA CGM's track record in takeover of companies such as Containerships on 31

October 2018, and Neptune Orient Lines Ltd ("NOL") in mid-June 2016, we think that CMA CGM has the business acumen and experience in corporate transformations to assist CEVA in delivering its expected adjusted EBITDA of USD470mn to USD490mn by 2021. Should the Public Tender Offer transaction and the acquisition of CCLog by CEVA go through, the benefits CEVA will reap are likely to positively affect CMA CGM.

- **Vertical integration for CMA CGM:** Investment in CEVA will allow CMA CGM to offer door-to-door service to its customers (broader product offering) and benefit from more commercial opportunities such as increased cross-selling. This is likely to translate into revenue synergies which can help counter parts of the inherent profit volatility in the container shipping industry, given its significant exposure to fluctuations in bunker fuel prices. In addition, CMA CGM's heavy asset base limits its flexibility to react swiftly to industry wide changes. As of writing, the potential transaction is in its initial stages and only with further details will we be able to estimate the value amount of these benefits to both companies. In addition, we must not discount the complexity of the Public Tender Offer transaction, the regulatory requirements both companies may be subject to as well as the time needed for the transformation to occur successfully and the eventual company to take shape.

- **Purchase may be debt funded:** Assuming that the Public Tender Offer goes through and CMA CGM becomes a controlling shareholder where CEVA's financial performance will roll up to CMA CGM's group performance, we estimate that the adjusted net gearing level of CMA CGM will be bumped higher to ~148%. This is prior to considering CMA CGM's outlay for the 7.88% stake in October, the debt CMA CGM might have to take up to finance the Public Tender Offer as well as the USD105mn cash payment receivable from CEVA for CCLog. Since 67% of CEVA's market cap of ~USD1.65bn is approximately USD1.1bn, less off the value CCLog will fetch, we think the maximum acquisition cost for CEVA to CMA CGM is around USD1.0bn. We see low possibility for the per share price offered to go higher (current offer price of CHF30.0 per share). Should (1) CMA CGM buy all of the remaining stakes in CEVA it does not already own and (2) The transaction is financed by 100% debt, we think net gearing may possibly surge to ~165% and consequentially, the credit profile of CMA CGM will weaken substantially in the short term relative to its current status. Having said that, we note that CMA CGM has yet to announce its funding plan for the Public Tender Offer.

Conclusion

On paper, CMA CGM's Public Tender Offer for CEVA and its sale of CCLog to CEVA appear to make strategic sense. Both parties look to benefit from cost, revenue and operational synergies. While management expects positive business impact, we think this is largely conditional on industry performance.

Given CMA CGM already owns a 33%-stake in CEVA, we think it is **highly possible for the deal to come through** and for CMA CGM to become a controlling shareholder of CEVA. Furthermore, CMA CGM is offering shareholders of CEVA a ~46% premium (with respect to the VWAP of CEVA over the 60 trading days prior to 1 October 2018). Even though shareholders have the option to remain invested in CEVA and exposed to the opportunity to capture the potential value creation proposed by the new strategic plan put out by CEVA and CMA CGM, the choice to exit their existing position for a significant premium is no doubt enticing. It is also worth noting that since CEVA's IPO on 3 May 2018 at CHF27.5 per share, its share price has fallen to a low of just CHF18.30 per share on 10 October 2018. As such, the Public Tender Offer could be perceived as a golden opportunity by shareholders looking to realise gains and exit their investments in CEVA.

In addition, CEVA's rejection of an unsolicited takeover from Denmark's DSV on 11 October 2018 at a price if CHF27.75 per share in cash citing that that proposal significantly undervalues CEVA's prospects as a standalone company and with CMA CGM as a strategic partner showcases CEVA's preference to partner CMA CGM and further supports the likelihood of the Public Tender Offer deal.

Having said that, we are keeping in mind that CMA CGM has yet to announce the funding methods for the Public Tender Offer, regulatory requirements deal parameters, and the final proportion of CEVA shareholders tendering would only be known when the deal completes. These can have significant impact on the deal and the credit health of CMA CGM. On the expectation that all shareholders take up the Public Tender Offer, we estimated an acquisition cost of ~USD1bn. While CMA CGM has sufficient cash on hand as at 30 September 2018 to fund the acquisition, we think liquidity looks tight given its ongoing cash needs in its regular course of business and expect CMA CGM to seek external financing. The company is also an unlisted entity which makes it more challenging for the company to seek equity fundraising, there has been no news with regards to the existing shareholders pumping in new money in support of the deal, net-net, in our view there is a high chance for the CEVA transaction to be predominantly debt-funded. This can stretch its gearing level and will most likely **put pressure on CMA CGM's Neutral (4) issuer profile**. We expect updates from CMA CGM in January 2019.

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IPR	Positive		Neutral			Negative	
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