Asia Credit Research

Earnings Review: Keppel Corporation ("KEP")

Recommendation

- KEP has a diversified profile which has helped defend its credit profile over the down cycle in offshore & marine ("O&M") over the past three years. Similar to 1Q2018, the Property segment was the largest contributor in 2Q2018, with en-bloc sales in China driving results.
- We see early signs of green shoots appearing in O&M and expect the orderbook to expand in the near term. Murmurs of possible infrastructure acquisitions in Singapore and Australia but not yet probable, we have not factored in the impact from these in our issuer profile for KEP.
- At the short end, we prefer the KEPSP 3.1% '20s over the SCISP 3.7325% '20s. This allows a spread pick up of 7bps, despite the six months longer maturity, we see KEP as having a stronger credit profile versus Sembcorp Industries Ltd ("SCI"). At the five-six year maturity area, we prefer the KEPSP 3.725% '23s over Keppel REIT's KREITS 3.275% '24s and see the SCISP 3.64% '24s as fair. The spread pick up of 26bps compensates for SCISP's weaker issuer profile. We hold KEPSP at an issuer profile of Neutral (3) and hold Sembcorp Industries Ltd ("SCISP") at Neutral (4).

Issuer Profile: Neutral (3)

Ticker: **KEPSP**

Background

Listed in 1986, Keppel Corp Ltd ("KEP") is a diversified conglomerate based in Singapore, operating in the offshore & marine ("O&M"), real estate and infrastructure sectors. Its principal activities include offshore oil rig construction, shipbuilding and repair, environmental engineering, power generation, property investment and development, and the operation of logistics and data centre facilities. KEP operates in more than 30 countries and is ~21%-owned by Temasek Holdings (Private) Ltd.

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Relative Value:

Bond	Maturity date/ Reset Date	Net gearing	Ask Yield	Spread
KEPSP 3.1% '20	12/10/2020	0.40x	2.58%	63bps
KEPSP 3.145% '22	14/02/2022	0.40x	3.02%	95bps
KEPSP 3.725% '23	30/11/2023	0.40x	3.31%	111bps
KREITS 3.275% '24	08/04/2024	0.39x[1]	3.25%	104bps
SCISP 3.7325% '20	09/04/2020	1.01x	2.44%	56bps
SCISP 2.94% '21	26/11/2021	1.01x	2.97%	92bps
SCISP 3.64% '24	27/05/2024	1.01x	3.52%	130bps

Indicative prices as at 03 September 2018 Source: Bloomberg, OCBC, Company
Net gearing based on latest available quarter; aggregate leverage for KREIT

Key Considerations

- **Credit profile remains defensible:** Revenue for 2Q2018 declined 2.0% y/y to SGD1.5bn mainly due to decline in Property (ie: property trading) and the Investments segment. Reported operating profit was up 73.6% y/y to SGD257.4mn though this was largely driven by other operating income of SGD120.3mn versus 2Q2017's other operating expense of SGD50.5mn. While Property's top line was lacklustre, KEP sold property development projects in China en-bloc which helped boost other operating income. Gain on disposal of an associate in Vietnam, and certain fair value gains and write-backs also contributed. EBITDA (excluding other operating income and other operating expenses) fell 29% to SGD180.6mn, though interest expense was down 1.3% y/y (on the back of lower average debt balance), resulting in still manageable EBITDA/Interest of 3.7x (2Q2017: 5.1x). As at 30 June 2018, unadjusted net gearing was 0.40x, slightly lower versus 0.42x as at 31 March 2018. Secured debt continues to make up only a small proportion of total debt and represents 1% of tangible assets which help boosts KEP's considerable access to debt markets.

- **Property segment driven by en-bloc sales:** In 2Q2018, KEP's property revenue declined 55% y/y to SGD244mn while we estimate operating profit at SGD214mn (up from the SGD99mn in 2Q2017). In 2Q2018, operating profit from the Property Development segment made up 83% of total operating profit. We think the decline in top line was driven by decline in revenue recognition from China and Vietnam property trading, though this was partly offset by expanded sales in other markets (eg: Indonesia and India). In property trading, we estimate that KEP sold 640 units in China and Vietnam collectively in 2Q2018 versus 1,360 units in 2Q2017. We estimate KEP's launched-ready residential projects in Singapore to fetch ~SGD1.2bn from 2H2018 to 2020. Bulk of these would come from 60%-owned

Garden Residences in Serangoon which is in competition with other new launches. Highline Residences was fully sold in 1Q2018 while KEP had been noticeably conservative in the recent en-bloc wave. In contrast, the launched-ready homes in China and Vietnam may fetch ~SGD6.0bn during the same period. Property's operating profit was higher, estimated at ~SGD214.2mn in 2Q2018 (2Q2017: SGD98.9mn), driven by whole-development/en-bloc sale of projects (in contrast to unit-by-unit sales) in KEP's integrated residential and marine lifestyle development in Zhongshan City, China and the sale of its project in Shenyang, China. Further en-bloc sales are likely, including the sale of KEP's 51%-stake in Aether Limited whose subsidiary is developing a prime commercial site in Chaoyang District in Beijing.

- **Offshore & Marine ("O&M") lacklustre in 2Q2018 though green shoots appearing:** In 2Q2018, KEP reported SGD607mn in revenue for the O&M segment (up 35% y/y) though reported a pre-tax loss of SGD11mn (against a pre-tax profit of SGD15mn in 2Q2017). We infer though that on an operating profit basis, the O&M segment was profitable, though very narrow at SGD6.0mn (2Q2017: SGD42.0mn). Part of the y/y decline in operating profit can be explained by 2Q2017's one-off gain (though this was small) and lower work volume. In May 2018, another five rigs were re-sold to Borr Drilling (three were originally ordered by third parties while two were speculative builds). While 2Q2018 O&M revenue had increased on the back of these re-sold rigs, these were sold at close to breakeven and do not translate into strong growth in operating profit line. KEP successfully delivered the second rig (part of those five novated from Transocean) to Borr Drilling after the first one was delivered in 1Q2018. As at 30 June 2018, net orderbook was SGD4.6bn (excluding the Sete Brasil projects) versus SGD3.9bn in end-2017 and this includes the USD425mn (~SGD560mn) contract win for a semi-submersible drilling rig (awarded by Awilco Drilling in March 2018). Per IHS Petrodata, jack-up rig utilisation is now ~76% for modern rigs built after 2000, significantly rising from the 70% in end-2017 and on the uptrend. While KEP has been developing solutions for the gas market (targeting floating LNG ("FLNG") conversion market), rigs would continue to be part of KEP's core activities in our view. With the divergence of demand for older jack-up rigs and modern rigs becoming more apparent, we think this would encourage more rig-building activities as we go into 2019 as customers start putting in orders to meet end-client demand.

- **Infrastructure is the second profit driver:** Revenue for the Infrastructure segment for 2Q2018 was SGD647mn (2Q2017: SGD521mn) while estimated operating profit was SGD35.4mn (2Q2017: SGD23.6mn), making up 14% of total operating profit. The increase in revenue was driven by progressive revenue recognition from the Keppel Marine East Desalination Plant project (~50% completed, targeted to be completed in January 2020) and from increased sales in its gas and electricity businesses. In 2Q2018, we think associates at KEP's Infrastructure segment recorded a loss of SGD2.1mn. KEP is the 49%-owner of Keppel Merlimau Cogen ("Merlimau"). The other 51% of Merlimau is owned by Keppel Infrastructure Trust ("KIT", an 18%-owned KEP associate). In 2Q2018, Merlimau recorded a loss after tax of SGD21.2mn as revenue was insufficient to cover finance costs, depreciation and amortisation. Though on a cash flow basis, Merlimau is cash generative. Reportedly, KEP may pursue Hyflux Ltd's Tuaspring intgerated desalination and power plant and on 30 August 2018, KIT is also reportedly considering to buy Ixom, an Australian chemical firm valued at more than USD1.0bn (~SGD1.37bn). Should these acquisitions transpire, capital raising would be necessary and we think the capital commitment and debt assumed will be contained within ~SGD1.8bn. Given that these purchases are possible but not yet probable, we have not factored in the impact from these in our issuer profile of Neutral (3) for KEP.

- **Firing on all cylinders in asset management:** While operating profit is centred on the Property Development and Infrastructure segments, Investments (mainly through the asset management arm Keppel Capital) is a significant driver for KEP's capital needs in the next 12 months. Keppel Capital comprise of KEP's 100%-ownership of Alpha Investment Partners (private real estate investment manager), stakes in REIT managers and Keppel-KBS US REIT. In end-2017, KEP's capital commitment was SGD1.3bn, with SGD450mn for commitments to private funds (end-2016: SGD170.0mn). In early August 2018, Keppel Capital announced the joint establishment of an AUD1.0bn (~SGD1.0bn) property fund to invest in retail assets with Australia-based Vicinity Centres. Common across real estate private equity funds, KEP is expected to hold up to 10% equity interest into the proposed fund (~SGD100mn). Alternative asset classes which Keppel Capital is also considering include a proposed early learning real estate fund. Outside of Keppel Capital, KEP also hold a 40%-stake in KrisEnergy Ltd and the 19%-stake in M1 Limited, both recorded as share of associates. Additionally, land sales from Sino-Singapore Tianjin Eco-City ("Eco-City") are recorded within Investments and lumpy. In 2Q2018, the Investments segment reported pre-tax profit of only SGD5mn against SGD55mn in 2Q2017. The absence of land sales from Eco-City in 2Q2018 vis-à-vis 2Q2017 could explain the lower profits for the segment. Additionally, we estimate that KEP recorded a loss from associates of SGD5.3mn in 2Q2018, led by continued losses at KrisEnergy.

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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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