Asia Credit Research

Earnings Review: Sembcorp Industries Ltd ("SCI")

Issuer Profile: Neutral (4)

Ticker: **SCISP**

Background

Sembcorp Industries Ltd ("SCI") was formed via the merger of Singapore Technologies Industrial Corporation and Sembawang Corporation in 1998. Today, SCI is focused on utilities (energy and water solutions), offshore marine (via its 61% stake in listed Sembcorp Marine ("SMM")) and urban development (focused on the development of industrial parks across the region). SCI has over 7,000 employees and generated SGD8.3bn in total revenue for 2017. Temasek Holdings is the largest shareholder of SCI, holding 49.5% stake.

Nick Wong Liang Mian, CFA
+65 6530-7348
NickWong@ocbc.com

Recommendation

- Like its peer Keppel Corp ("KEP"), SCI is now able to monetize the Marine assets on its balance sheet given the broad recovery in the O&M sector. The Utilities segment has also benefitted from both the recovery of the domestic power business, as well as the ramp up of its India power business. Profitability remains weak for both segments, with competition pressuring Marine, while the power surplus situation drove a loss in India.
- Despite margins pressures, SCI had reverted to positive operating cash flows. The India power IPO could further deleverage SCI's balance sheet. That being said, our Neutral (4) Issuer Profile for SCI already factors some of these potential positive trends in its credit profile.
- We find the SCISP seniors relatively rich, especially when compared against the KEPSP (Issuer Profile (3)) curve when KEP benefits from a strong property segment as well as distinctly lower leverage. The most interesting perp would be the SCISP 4.75%-PERP given the high carry and near-term 1st call date (our base case is that SCI would call the perp). In the event that the perp is not called, the yield-to-reset of 4.6% for ~7y till reset (spread above swaps of ~200bps) still looks fair given when the senior bonds are trading.

Relative Value:

Bond	Maturity/Call date	Net Gearing	Ask Yield	Spread
SCISP 2.94% '21s	26/11/2021	89%	3.2%	87bps
SCISP 4.75%-PERP	20/05/2020 (1st call)	89%	4.3%	214bps
KEPSP 3.145% '22s	14/02/2022	42%	3.1%	74bps

Indicative prices as at 9 May 2018 Source: Bloomberg
Net gearing based on latest available quarter

Key Considerations

- **Twin drivers finally synchronizing**: SCI reported 1Q2018 results. Revenue surged 30.0% y/y to SGD2.76bn, with Utilities (+14.2% y/y to SGD1.51bn) and Marine (+58.3% y/y to SGD1.18bn) both reporting strong revenue growth. Though it was noted that Marine performance benefitted in part by accounting changes (which will be discussed in detail later), excluding the accounting effects Marine revenue would have been SGD858mn, still up 15.1% y/y and 31.0% q/q. In terms of earnings contribution though, the Utilities segment continues to deliver the lion's share, generating ~90% of group net profit, with the difficult environment still suppressing Marine profitability.

- **China performance drove Utilities profit**: The Utilities segment revenue was supported by the sustained recovery in the domestic power generation business, with higher heavy sulphur fuel oil ("HSFO") prices driving Singapore electric tariffs higher. This caused Singapore's revenue contribution to increase 10.2% y/y to SGD826.2mn. The other big contributor was India, which saw revenue increase 21.7% y/y to SGD441.1mn due to the ramp up of the second thermal power plant at Sembcorp Gayatri Power Limited ("SGPL") after it commenced commercial operations in February 2017. Utilities net profit increased 27.1% to SGD70.3mn (net margin of 4.7%), largely due to China's net profit contribution surging 48.0% y/y to SGD32.7mn. Management attributed this to the Songzao, Chongqing power plant (SCI owns a 49% stake in the facility) which saw its second 660MW unit commence operations in January 2017. Comparatively, despite strong revenue growth, net profit from Singapore was flattish y/y while India continued to generate losses. That being said, management expects the India energy operations to turnaround to profitability in 2018. Separately, as disclosed in SCI's 2017 annual report, a market study by CRISIL was published, projecting that India current peak power surplus is expected to reverse by the Indian fiscal year ending March 2020. Key to SCI's India utilities business in swinging into profitability would be the second SGPL power plant entering into a long-term PPA.

- **Profits remain elusive at Marine**: The Marine segment (largely SMM) saw revenue spike 58.3% y/y to SGD1.18bn, driven by the delivery of two jack-up rigs to Borr Drilling and one jack-up rig to BOTL. The adoption of SFRS(I) 15 accounting standard also resulted in some changes to how revenue is being recognized (revenue to be recognized for constructed assets upon delivery versus the earlier percentage of completion method). Prior results were also restated. Margins remain weak due to competition, while segment net profit fell 92.0% to SGD1.8mn, due to the absence of SGD46.8mn disposal gain recognized on the sale of SMM's 30% stake in Cosco Shipyard Group in 1Q2017. Looking forward, SMM's management had guided that though upstream activity is picking up, the oversupply situation in drilling assets has persisted, pressuring utilization and day rates. As such, the recovery of new orders for drilling assets will take some time.

- **Modest operating cash flows generated offset by deleveraging and restructuring**: Group net profit fell 40.0% y/y to SGD78.5mn, as aside from the contributions from Utilities and Marine, SCI's Urban Development segment reported a 74.2% y/y decline in net profit to just SGD9.6mn, given the absence of gains on Nanjing land sales seen in 1Q2017. Operating cash flow (including interest service) was fair at SGD97.6mn. Given SGD50.5mn in capex, free cash flow was SGD47.1mn. In terms of outflows, SCI paid down SGD223.5mn in net debt. It had also spent SGD291.6mn acquiring non-controlling interests (this relates to SCI's reorganizing of its India energy business in preparation for the IPO). In total, SCI saw a cash outflow of SGD440.6mn during the quarter, which was funded by its cash balance (ended 1Q2018 at SGD2.23bn). This drove net gearing higher q/q to 89% (4Q2017: 88%). Short-term debt of SGD1.81bn looks manageable as it can be met by SCI's cash balance. EBITDA/Interest had improved as well to 2.7x for the quarter (2017: 2.0x)

- **Some details on the SEIL IPO**: During 1Q2018, SCI had restructured its India energy business under one entity: Sembcorp Energy India Limited ("SEIL"). As part of the process, SCI had bought out and transferred around minority interests. Based on the draft red herring prospectus regarding SEIL's IPO, SCI is seeking to raise fresh equity of up to INR40.95bn (~SGD820mn) and offer up to 146.8mn existing shares (with SCI providing 128.9mn shares). Pre-IPO, SEIL's outstanding shares stand at 5.16bn (with SCI controlling a 93.7% stake). As SCI had indicated only the divestment of a minority stake in SEIL, SEIL will remain consolidated in SCI's results. The proceeds from the IPO could allow SCI to further deleverage its balance sheet (aside from the on-going monetization of its Marine inventory). The timing and feasibility of the IPO is uncertain at present. We note that based on SEIL's pro-forma condensed consolidated statement for 1HFY2018 (ending September 2017), SEIL generated a net loss of INR3.2bn on revenue of INR40.5bn, largely due to SGPL.

OCBC Global Treasury

Treasury Advisory	Credit Research
Corporate FX & Structured Products Tel: 6349-1888 / 1881 **Interest Rate Derivatives** Tel: 6349-1899 **Investments & Structured Products** Tel: 6349-1886 **GT Institutional Sales** Tel: 6349-1810	**Andrew Wong** +65 6530 4736 WongVKAM@ocbc.com **Nick Wong Liang Mian, CFA** +65 6530 7348 NickWong@ocbc.com **Ezien Hoo, CFA** +65 6722 2215 EzienHoo@ocbc.com **Wong Hong Wei** +65 6722 2533 wonghongwei@ocbc.com

Explanation of Issuer Profile Rating / Issuer Profile Score

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 into a 7 point Issuer Profile Score 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.

Co.Reg.no.:193200032W