Issuer Profile: -
Neutral (4)
⬇
Neutral (5)

Ticker:
SCISP

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Sembcorp Industries Ltd ("SCISP")

Recommendation

- **SCISP's credit profile continues to be supported by its Energy (formerly Utilities) segment which continued to be the largest contributor to profit from operations at SGD231mn in 2Q2019 (up 7% y/y). Driven by higher average debt balance, EBITDA/Interest coverage was 2.1x, somewhat lower than 1Q2019's 2.3x.**
- **While unadjusted net gearing optically looks in line with end-1Q2019 at 1.08x, we think SCI's financial support to its marine subsidiary that is still facing sector challenges means that SCI's net gearing has likely increased post-quarter end to 1.2x based on our estimation.**
- **While we understand the need of a parent company to fund its subsidiary, the absence of equity funding has meant that the burden of that financial support has fallen on bondholders. SCI, already a levered company, no longer meets our issuer profile of Neutral (4) on the company are we are lowering the issuer profile to Neutral (5).**
- **We are underweight both the short dated SCI bonds, the SCISP 3.7325% '20s and SCISP 2.94% '21s and prefer Keppel Corp Ltd ("KEPSP")'s short dated bonds. We hold KEPSP at an issuer profile of Neutral (4). We are neutral the SCISP 4.75%-PERP though we continue to think that there is a good chance that this perpetual will be called at first call. We are now neutral the SCISP 3.7%-PERP, with the perpetual trading at a yield to reset in June 2022 of 3.9% (yield to call of 4.4%), though we see the probability of call at first call in June 2020 as low.**

Relative Value:

Bond	Maturity / Call date	Reset date	Net gearing	Ask YTM/YTC	Spread
SCISP 3.7325% '20s	09/04/2020	NA	1.1x	2.18%	45bps
SCISP 2.94% '21s	26/11/2021	NA	1.1x	2.62%	105bps
SCISP 3.64% '24s	27/05/2024	NA	1.1x	2.97%	145bps
SCISP 3.593% '26s	26/11/2026	NA	1.1x	3.34%	176bps
SCISP 4.75%-PERP	20/05/2020	20/05/2025	1.1x	3.92%	221bps
SCISP 3.7%-PERP	22/06/2020	22/06/2022	1.1x	4.36%	268bps
KEPSP 3.1% '20s	12/10/2020	NA	0.8x	2.25%	62bps
KEPSP 3.145% '22s	14/02/2022	NA	0.8x	2.53%	97bps
KEPSP 3% '24s	07/05/2024	NA	0.8x	2.78%	126bps

Indicative prices as at 26 August 2019 Source: Bloomberg
Net gearing based on latest available quarter

Background

- Sembcorp Industries Ltd ("SCI") focuses on utilities (energy and water solutions), offshore marine (via its 61%-stake in Sembcorp Marine Ltd ("SMM")) and urban development (focused on development of industrial parks across the region). SCI is listed on the Singapore Stock Exchange with a market cap of SGD4.0bn as at 23 August 2019. Temasek is the largest shareholder of SCI with a ~49.5%-stake.

Key Considerations

- **Energy segment (renamed from "Utilities") drives profit:** SCI's overall revenue was down by 29% y/y to SGD2.4bn mainly due to the decline in top line from its Marine segment (ie: 61%-owned Sembcorp Marine Ltd which is consolidated into SCI) and a 6% y/y decline in the Energy segment to SGD1.6bn. In 2Q2019, SMM's revenue declined 55% y/y to SGD731mn mainly driven by the decline in top line in the Rigs & Floaters segment (down 61% to SGD542mn) and offshore platform projects. The smaller but more stable contributor, Repairs & Upgrades segment, saw a 13% y/y increase to SGD142mn though Offshore Platforms declined by 60% y/y to SGD34mn. SCI though saw a 21% y/y overall increase in reported profit from operations ("PFO") to SGD232mn. The Energy segment continued to be the largest contributor to PFO at SGD231mn (up 7% y/y). Despite the fall in Energy top line, share of results from associates and joint ventures which forms part of Energy PFO had increased to SGD36mn (2Q2018: SGD16mn).

- **India Energy performed stronger with SCI injecting capital to grow this business:** For Energy PFO, the biggest geographical contribution was from India (61% contribution in 2Q2019). India Energy PFO grew 9% y/y to SGD140mn in 2Q2019, driven by lower cost of coal and stronger performance in renewable power. SCI was earlier preparing for an IPO of its India Energy business, though had withdrew the IPO until a later date. In July 2019, SCI had injected SGD101.6mn to expand the India renewable energy business. While this capital injection is manageable for now, we expect more funding from SCI to be required as we do not expect an IPO to happen in the near term.

- **Other key Energy markets:** UK Energy saw a loss from operations of SGD19mn in 2Q2019 (2Q2018: PFO of SGD1mn), while this may be explained by seasonality of the business, per company, UKPR was also facing a challenging merchant market and continued suspension of capacity payments (since November 2018). Singapore, the second largest market by PFO reported SGD51mn of PFO in 2Q2019 (2Q2018: SGD63mn), the decline was in part driven by higher marketing costs on its electricity retail business.

- **EBITDA/Interest coverage somewhat lower:** Based on our calculation which does not include other operating income and expenses, overall EBITDA was SGD310mn in 2Q2019, while interest expense was SGD147mn (minimal impact from interest on lease liabilities). Interest expense was higher mainly due to higher average debt from acquiring UKPR and higher working capital needs at SCI on a standalone basis. As such resultant EBITDA/Interest coverage was 2.1x, somewhat lower than 1Q2019's 2.3x.

- **SMM outlook challenging still:** SMM saw a narrower loss from operations of SGD5mn in 2Q2019 versus a loss from operations of SGD51mn in 2Q2018. However, per company, the group's net orderbook excluding Sete Brasil contracts as at 30 June 2019 was SGD2.1bn (31 March 2019: SGD2.65bn and 31 December 2018: SGD3.09bn). Effectively, SMM had not been able to replenish its orderbook with only SGD175mn in new contracts secured in 1H2019. SMM shared that it is expecting losses for 2H2019 to be higher than 1H2019 with 2019 losses projected to be in range with 2018 losses. For 2018, SMM reported a loss for the year (before tax) of SGD100.9mn and net loss after tax credits of SGD78.4mn.

- **Lower orderbook though helps cash conservation in the short term:** While the decline in orderbook would continue to drag the profitability of SMM, in our view, this also means that less working capital needs is required in the immediate to near term which reduces the cash outflow of SMM (as a knock on effect reduces further need for SCI to support SMM's working capital). In 1H2019, SMM reported cash flow from operations (after tax but before interest) of SGD296.6mn versus a negative cash outflow of SGD48.7mn in 1H2018 in part as SMM had collected on receivables from completed projects. In 2Q2018, based on our calculation which does not include other income and other expenses, SMM had a loss before tax, depreciation, amortisation and interest of SGD9.5mn, though in 2Q2019, it generated an EBITDA of SGD49.4mn, which covered interest expenses by 1.5x (including interest expense on lease liabilities).

- **Financial support to SMM puts a damper on SCI's credit outlook:** On 21 June 2019, SCI announced that it will be lending SMM SGD2.0bn, of which SGD0.5bn will be for working capital and general corporate purposes. Per SMM, SGD1.5bn was drawn down on 8 July 2019 to help pay down short term borrowings and re-profile the remaining borrowings with longer term maturities. Conceptually, a parent company financially supporting its subsidiary is par for the course, though did strike us as unusual that the refinancing needed to be fulfilled via a new privately placed bond issued by SCI (ie: the SCISP 3.55% '24s) rather than via existing facilities and banking relationships. In end-2018, SCI's unutilized committed funded facilities were SGD2.4bn while its unutilized uncommitted funded facilities and unutilized trade-related facilities were SGD1.1bn and SGD2.7bn respectively, which, together with cash balances of SGD1.9bn then was significant against short term debt due of SGD1.9bn. Per company though, SMM is able to borrow on a standalone basis though would require a higher cost of funding and the transaction allowed SMM to term out its debt.

- **Not imputing shareholder support for issuer profile uplift:** While SCI's key shareholder was also an investor in the bonds (exact quantum undisclosed), it is insufficient for us to impute this as shareholder's support to uplift SCI's issuer profile from Neutral (5). Right before the announcement of the proposed new bond, the SCISP bond of a similar tenor was trading at 3.12%, with the new bond priced at 3.55%, at a ~40bps premium. For most of 2018 and until June 2019, we took comfort that SCI had been trying to strengthen its levered balance sheet, include selling non-core assets to generate cash. In particular, SCI's consolidated balance sheet was already stretched prior to announcement with net gearing of 1.09x as at 31 March 2019. With the financial support to SMM, we no longer view SCI as on a deleveraging path.

- **For now balance sheet more stretched**: As at 30 June 2019, unadjusted net gearing for SCI on a consolidated basis was 1.08x, at very similar levels to 31 March 2019 numbers. We estimate that SCI's cash balance on a standalone basis was SGD1.3bn (SGD1.2bn as at 31 March 2019), which in our view has also not factored in SGD0.5bn to be allocated for SMM's working capital purposes. We think the final incremental impact to consolidated net gearing would be contained to the SGD0.5bn in working capital funding, with the other SGD1.5bn for SMM's refinancing as a "right hand to left hand" transaction since SMM is consolidated into SCI. In July 2019, only SGD0.9mn had been used for refinancing, although the full SGD1.5bn in new debt had been raised. We assume that post quarter end, SCI's consolidated net debt had increased by SGD1.1bn with net gearing stretched to 1.2x for now. Our assumption is premised on (1) SGD900mn of short term debt that has been repaid at the SMM (2) SGD1.5bn in new bonds placed at the SCI level and (3) SGD0.5bn in cash to be allocated from SCI to SMM for SMM's working capital.

- **More questions on Borr while heightened event risk does not help:** Earlier, we had pointed out that SMM was due to receive cash from Borr Drilling (Issuer Profile: Unrated, "Borr") over the next five years (SGD1.2bn from rigs sold and delivered by SMM). The exact payment schedule is not disclosed although the last payment will be received in 2024. We are turning cautious over the financial health of Borr, with its market cap down 53% from our update in May 2019 and 46% from our Mid-Year 2019 Credit Outlook update on SCI. The SGD1.2bn cash infusion had not been factored into our issuer profile for SCI and we are leaving it as a potential upside at best. On 3 July 2019, SMM announced that Brazilian authorities have executed a search warrant on its subsidiary in Brazil in connection with Operation Car Wash. We continue to monitor developments. While it is too premature for us to comment on the knock on effects, we note that Keppel Corp Ltd ("KEP") (Issuer profile: Neutral (4)) whose subsidiary in Brazil was affected in Operation Car Wash took a one-off hit from global resolution and related costs of SGD619mn in FY2017. SCI is yet to make any similar adjustment at this time.

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

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

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.

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