Asia Credit Research

OCBC Bank

BreadTalk Group Ltd: New Credit Review

Monday, November 07, 2016

Recommendations Summary

Issuer Profile:	**Bond Recommendation:**	
Neutral	BREAD 4.6 '19	**Overweight**
Fundamental Analysis Considerations • Strong cashflow generation • Focus on performance over rapid expansion • Diversified brand portfolio	Technical Analysis Considerations • Visible retail presence and household name • Short duration with decent yield • Small issuance size	

S&P: Not rated
Moody's: Not rated
Fitch: Not rated

Ticker: **BREAD SP**

Treasury Advisory
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

GT Institutional Sales
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Key credit considerations

- **Posting better results after the high growth phase:** After the rapid expansion of outlets over the years, BreadTalk Group Ltd ("BGL") has consolidated its business with cost controls and closing unprofitable outlets. In the latest 3Q2016 results, EBITDA from its three divisions (Bakery, Food Atrium, Restaurant) increased 23% y/y to SGD21.7mn. We think BGL may continue to post good results with further operational efficiency gains. Another boost to earnings would come from the decrease in write-offs as BGL should be mostly done with the closure of unprofitable outlets.

- **Not worried over dependence on Din Tai Fung ("DTF"):** We estimate DTF accounts for over 80% of the revenue of the Restaurant Division, which in turn comprises c.47% of BGL's EBITDA from all three divisions. As such, any impact on the continuation of the DTF franchise agreement, which will expire on July 2021, will materially impact BGL. Nevertheless, we note that BGL has been successfully running the DTF franchise since 2003. Management expressed confidence in the continuation of the DTF franchise given the track record by BGL while the franchisor's interest is aligned with its 20% stake in the DTF JV. Meanwhile, the Bakery and Food Atrium results have been picking up, which reduces the dependence on DTF.

- **Benefits from stakes in property assets:** BGL holds stakes in CHIJMES, AXA Tower and TripleOne Somerset. These help BGL to secure locations for its stores while the income mitigates rental costs. We note the potential to liquidate such stakes for cash, for example from BGL's sale of 112 Katong for SGD16mn in Jan 2016.

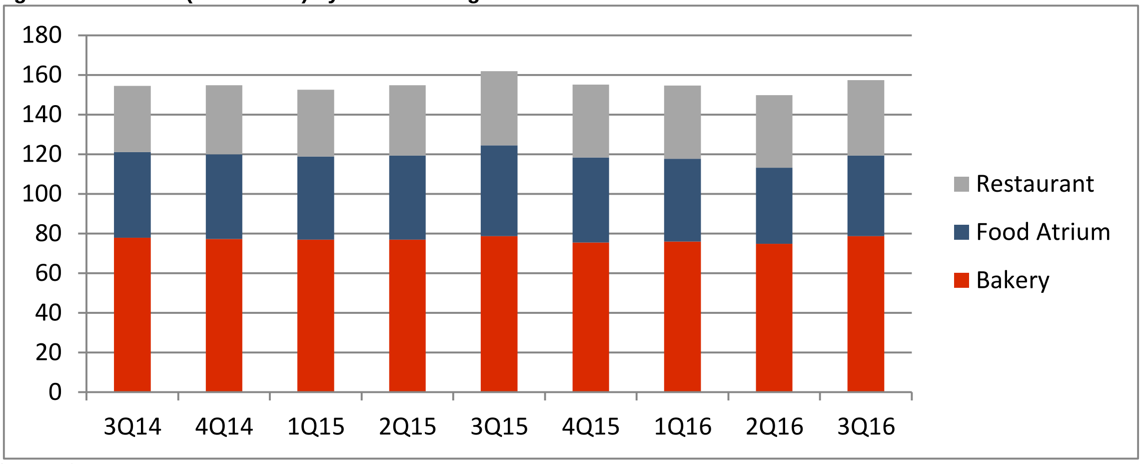
- **Good credit metrics from healthy cash flows**: Masked by high depreciation which impacted profitability (Net margins: typically between 1-3%), BGL has been recording strong cash flows. Net debt/equity of 0.55x is manageable, with a healthy 1.7x Net debt/Equity. Gearing ratio has been trending lower since FY2013 and we expect the balance sheet to improve further as BGL is no longer aggressively expanding. Liquidity is ample with SGD112.5mn of cash. We like that BGL has been paying down short-term debt and stretching out the debt maturity profile

- **Technical factors:** Despite no close comparables in the SGD market, BGL is a household name with strong retail presence in Singapore. The short duration 2.4-year paper offering 3.61% yield looks attractive, in our view.

I) Company Background

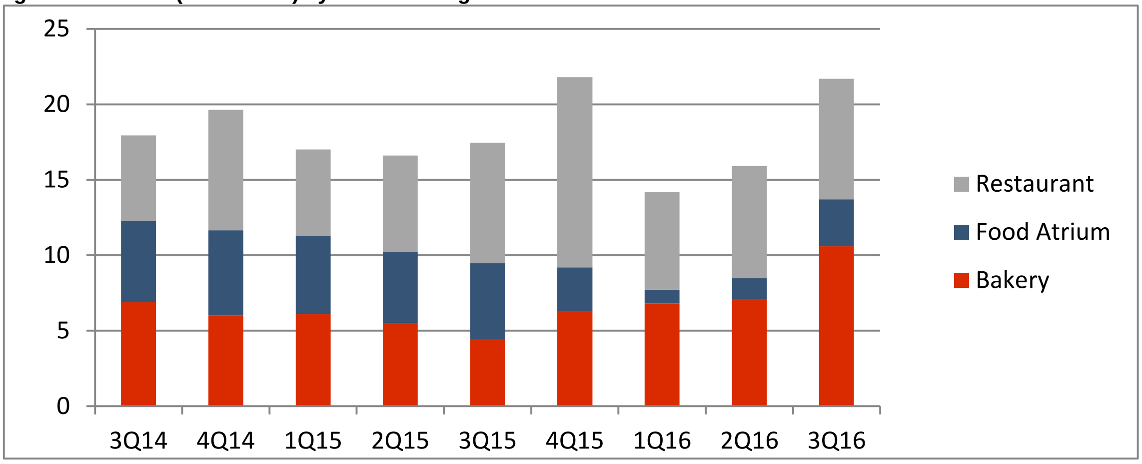
Listed in Singapore on 6 March 2003, BreadTalk Group Ltd ("BGL") is a household F&B brand owner. Since 2003, the company has expanded beyond Singapore and currently operates 957 outlets in China, Singapore, Thailand and other parts of Asia and Middle East. BGL classifies its businesses into 3 main segments: (1) Bakery, (2) Food Atrium, (3) Restaurant.

Figure 1: Revenue (in SGD mn) by business segment



Source: Company

Figure 2: EBITDA (in SGD mn) by business segment



Source: Company

<u>Bakery Division</u>

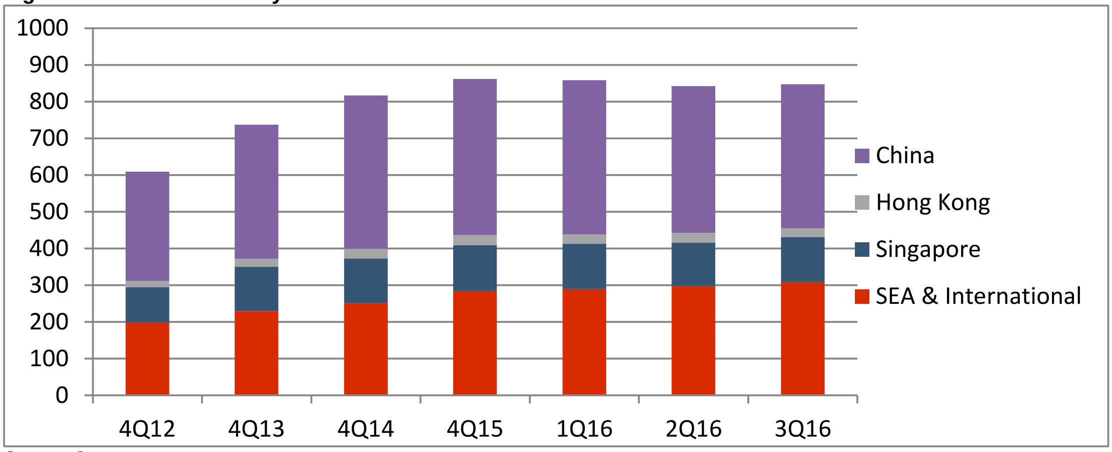
Comprising 50% of BGL's revenue in 9M16, household brands under the Bakery Division include *BreadTalk*, *Toast Box*, *Thye Moh Chan*, *Bread Society*, and *The Icing Room*. Singapore and China accounts for 87% of 9M16's revenue while Hong Kong and the rest of SE Asia contribute most of the remainder.

Figure 3: Bakery Division brands

Source: Company

After having quickly expanded the number of outlets, BGL has begun to moderate the pace of BGL-owned outlet expansion[1] after 2Q15 in China and Singapore. The focus is on cost control and quality of earnings. Meanwhile, BGL is still growing its Bakery presence in Southeast Asia. In Thailand, BGL, through its 49%-owned associate BreadTalk (Thailand) Co Ltd, has a strategic partnership with Minor Food Group PCL to further develop the BreadTalk brand.

Figure 4: Number of Bakery outlets

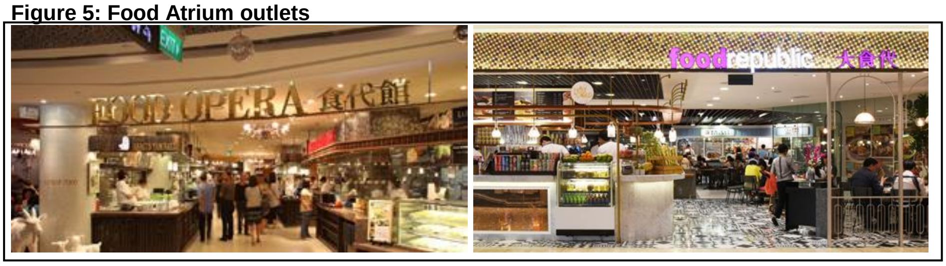


Source: Company

<u>Food Atrium Division</u>

Under the Food Atrium Division, BGL operates via the brands *Food Republic* and *Food Opera*. Food Atrium comprises 26% of BGL's 9M16 revenue, with Singapore, China and Hong Kong making up 91% of the division's total revenue.

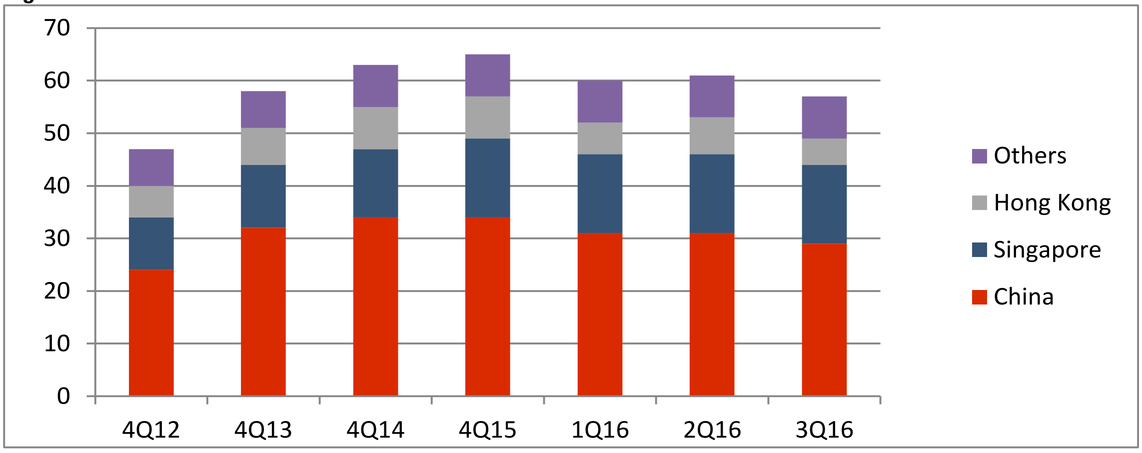
Figure 5: Food Atrium outlets



Source: Company

Similar to the Bakery Division, BGL undertook an evaluation process to close a number of underperforming outlets after a period of strong growth in outlets.

Figure 6: Number of Food Atrium outlets



[1] Not all outlets are self-owned. 589 Bakery stores as of 3QFY16 are under BGL's franchisees.

Source: Company

<u>Restaurant Division</u>

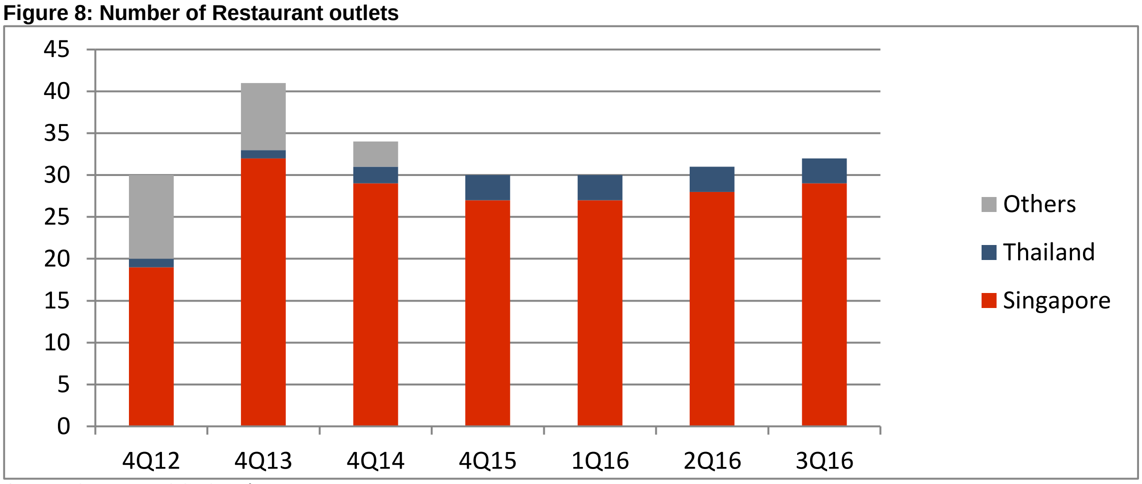
Din Tai Fung ("DTF") is the crown jewel under the Restaurant Division, which generated SGD26.7m of profit after tax in FY2015. BGL holds the franchise rights of DTF through Taster Food Pte Ltd, which is a 70% joint venture entity. Din Tai Fung Co Ltd holds 20% interest in Taster, while the remaining 10% is held by Taiwanese individuals. We understand from management that the Singapore DTF franchise expires on July 2021. Other brands under the Restaurant Division include RamenPlay and Sanpoutei Ramen.

Figure 7: Restaurant brands

Source: Company

Having expanded rapidly over 4Q12-4Q13, BreadTalk began to downsize the underperforming outlets, for example by pulling out RamenPlay from the China market. As of 3Q16, most of the restaurant outlets are DTF - 20 outlets in Singapore and 3 outlets in Thailand.

Figure 8: Number of Restaurant outlets



Source: Company, OCBC estimates

II) Ownership and Management

Figure 9: Major shareholder as at 07/11/16

Investor	Shares	Stake
George Quek Meng Tong	95,687,660	34.01%
Katherine Lee Lih Leng	52,415,020	18.63%
Primacy Investment Limited	36,626,800	14.03%
Paradice Investment Management LLC	17,034,224	6.33%

Source: Bloomberg

George Quek, Chairman, and his spouse Katherine Lee, Deputy Chairman, own 52.64% of BGL. Both are also the founders of BGL and have been directors of the company since 6 Mar 2003. George Quek has over 30 years of experience in the F&B industry, including starting an F&B business in Taiwan in 1982, which grew into a chain of 21 Southeast Asian food outlets. George Quek also founded Topwin Singapore and Megabite China.

Primacy Investment Limited is a fully-owned subsidiary of Minor Food Group PCL, which is in turn 99.7% held by Minor International Public Co Ltd. Minor International Public Co Ltd ("MINT") is a hospitality and leisure company with over 150 hotels and resorts, 1800 restaurants and 300 retail trading outlets. MINT is listed in Bangkok with a market cap of THB170.9bn. Paradice Investment Management LLC is a privately owned Australian boutique fund.

III) Company Overview & Analysis

- **Decent 3QFY16 results:** While revenue inched lower by 2.7% y/y in 3QFY17, net profits increased 57.3% y/y to SGD5.4mn mainly due to improvements in gross margins (due to improvements in supply chain management) and lower distribution and selling expenses. Performance across BGL's divisions differ:
    - **Bakery:** The Bakery division saw an impressive 142% surge in EBITDA to SGD10.6mn in 3QFY16 due to cost controls (e.g. improvement in supply chain management, cutting wastage, better staff scheduling) and better performance from BGL-owned stores. Management expects margins to continue improving from further operational efficiency gains. However, revenues held steady as franchisee income from China is lower. The number of franchisees may decrease as they have not fared well.
    - **Food Atrium:** EBITDA for the Food Atrium business declined 37.9% y/y to SGD3.1mn in 3QFY16, which we believe is due mainly from the write-offs from closures of several food courts in China. We think the rate of write-offs will slow as BGL is mostly done with the evaluation of the underperforming outlets. In addition, BGL will no longer pursue any outlets outside of China first tier cities and instead will only expand in areas that they have a good track record of operating in.
    - **Restaurant:** EBITDA fell 2.5% y/y to SGD8.0mn in 3QFY16, which management thinks is due to the high base effect from SG50 last year when BGL sold seasonal products. While DTF is transitioning into a slower growth phase, management is working on improving cost issues at RamenPlay.

- **Not worried over dependence on Din Tai Fung:** Restaurant Division is the biggest contributor of BGL's EBITDA over 3QFY15 to 2QFY16, and we estimate that DTF accounts for over 80% of the Restaurant Division's revenue. As such, any impact on the continuation of the DTF franchise agreement (till July 2021) will have a material impact to BGL's earnings and cashflows. Nevertheless, we note that BGL has been operating the DTF franchise since 2003, and has demonstrated its capabilities as a franchisee by growing the number of outlets to 23 as of 2QFY16. Management expressed confidence in the continuation of the DTF franchise in Singapore. Din Tai Fung Co Ltd (the franchisor) has an interest in the continuation of the franchise, given that it holds 20% of the DTF joint venture. Meanwhile, DTF has been BGL's best performer, with the Restaurant Division latest 12 month (4QFY15 to 3QFY16) EBITDA increasing 23% to SGD34.5mn.

- **Focus on performance over rapid expansion:** After rapidly increasing the outlets over the years, BGL has begun focusing on cost control and moderating the pace of expansion. The performance of the Bakery Division has been turning around, with EBITDA increasing from the recent lows of SGD4.4mn in 3QFY15 to SGD10.6mn in 2QFY16. After completing the review of its Food Atrium Division and closing 9 underperforming stores in Mainland China and Hong Kong, which resulted in write-offs of property, plant and equipment (9MFY2016: SGD 4.8mn), we look towards better results. For the Restaurant Division, we like that BGL has already closed the underperforming RamenPlay stores in Mainland China while same store sales continues to grow. We believe that BGL is facing saturation of growth in the Singapore market for all its segments. Although this creates a drag on earnings growth with slower expansion, this is credit positive as we expect BGL to commit less cash to new outlets, and new outlets take time to breakeven in cashflow.

- **Benefits from partial stakes in property assets:** BGL holds a 29% stake in CHIJMES (Book value: SGD 18.0mn), 5.3% in AXA Tower (Book value: SGD 19.4mn) and a stake in TripleOne Somerset (Book value: SGD 17.2mn). As part of the development pipeline, BGL also holds a 5.7% stake in Perennial Tongzhou Development Pte Ltd (Book value: SGD 20.1mn) and a 5.9% stake in Perennial Tongzhou Holdings Pte Ltd (Book value: SGD14mn). While these are not core to BGL's F&B business, they help BGL by 1) securing locations for

BGL's brands at the malls and 2) getting the first right of refusal to retail space at the malls. The income from these properties mitigates rising retail rental costs, while the ownership from these properties may provide long-term capital upside. For example, the divestment of 112 Katong netted BGL a gain of SGD8.5mn. Aside from the retail properties, BGL owns 18 units of office space in Shanghai (Book value: SGD22.4mn).

- **Strong branding offer franchising opportunities:** Sales to franchisee and franchise income[2] comprise SGD43.0mn out of 2015's bakery revenue of SGD265mn. While the composition of revenue is small, we believe the margins from franchising are better than revenue from BGL operated stores. The franchise model also allows BGL to expand with an asset-light model and reduce capex requirements which minimises the downside from store expansion. As a result, franchise stores comprise the majority of the Bakery Division (589 out of 847 stores). While BGL faces headwinds in China, Myanmar Bakery Co Ltd (member of Shwe Taung Group) signed a franchise agreement on 3 May 2016 to establish a BreadTalk bakery chain in Myanmar, a testimony that BGL's branding is still strong.

- **Wide brand portfolio with increasingly diverse geographical footprint:** While performance between brands varies, EBITDA for each Division (Bakery, Food Atrium, Restaurant) has been positive. In addition, BGL's footprint is diverse, with 45% of revenues derived out of Singapore in 9MFY16, with the bulk of overseas income from China and Hong Kong. Contribution from overseas may grow further with planned expansion in China, Thailand and Myanmar.

IV) Financial Analysis

- **Strong cashflow generation:** Though BGL has been reporting weak profitability (net margins typically average 1-3%), the true potential has been masked by write-offs and depreciation. Write-offs due to store closure amounts to SGD6.3mn in 9M2016, which is sizeable compared to profit before tax of SGD19.2m. Net debt/EBITDA is very healthy at 1.7x as of 9MFY16 – our figure is conservative as we do not take into account other income (some of it is non-recurring in nature) and income from JVs/associates. FCF has been growing since FY2014, with 9M2016 FCF of SGD30.9mn already exceeding FY2015's SGD28.9mn. Our adjusted FCF was negative in FY14 and FY15, as this was due mainly to acquisitions (e.g. purchase of office units in China, stake in AXA tower and stake in TripleOne Somerset).

- **Expect improvements to cashflows and margins:** Maintenance capex is lower than depreciation, as we note that capex in 9M16 of SGD30.6mn (which includes 1 new Food Atrium outlet and 3 DTF outlets) is already lower than the depreciation expense of SGD36.2m. Given that BGL is no longer looking to expand aggressively, we expect capex to trend lower in FY17. We also expect EBITDA margins to improve as we believe BGL is largely done with the closure of the underperforming Food Atrium stores while tightening cost controls and improving the supply chain in the Bakery division.

- **Decent credit metrics:** Net debt/equity has decreased to 0.55x as of end-9M2016 (FY2015: 0.73x) due to falling net debt while BGL generates strong cashflows. We think BGL's book equity may understate the real value given that BGL adopts an aggressive depreciation policy for PPE on its books (typically depreciated over 3Y-5Y). However, we also note that BGL provides corporate guarantees to its subsidiaries (end-FY2015: SGD156.3mn). Meanwhile, liquidity is ample with SGD112.5mn of cash, and BGL has been paying down short-term debt since end-FY2015. BGL issued a 2019 bond in Mar 2016, which pushed out the debt maturity profile further.

[2] Refers to revenue paid to BGL by the franchisee. Not inclusive of revenue of the franchisee.

- **Value in the balance sheet:** BGL holds stakes in several properties, including CHIJMES, AXA Tower, TripleOne Somerset, Beijing Tongzhou Development and office space in Shanghai. While we believe a number of these assets have been pledged, we note the potential to liquidate such stakes for cash, for example from the sale of 112 Katong.

V) Technical Considerations

Positives

- Visible retail presence and household name for local investors
- Change of shareholding clause
- Short duration with decent coupon mitigates interest rate risk

Negatives

- Few close comparables
- Lack of credit rating
- Small issuance size

Relative Value

Issue	Maturity	Ask Price	Ask YTW	Net debt/Equity	Net debt/EBITDA
BREAD 4.6 '19	01/04/2019	102.25	3.61	0.55x	1.7x
COURTA 5.75 '19	15/03/2019	102.35	4.68	0.84x	3.5x
FCTSP 2.9 '19	10/04/2019	100.75	2.58	0.40x	6.3x
CAPITA 3.15 '20	18/12/2020	103.75	2.19	0.41x	6.2x
SGREIT 3.5 '21	26/02/2021	103.50	2.63	0.52x	6.9x

*Indicative spreads based on offer prices from Bloomberg on 04/11/16

Acknowledging that BGL does not have close comparables in the SGD market, we compare BGL to Courts Asia. Both have visible retail presence in the Singapore market, typically operate in malls and have a market cap in the range of SGD200mn+. While COURTA '19s offers 107bp pickup over BREAD '19s, we think Courts should naturally trade at a significantly wider yield given its poorer credit metrics with higher gearing, higher net debt/EBITDA. The net debt of Courts has also been increasing with negative free cash flows in most of the recent years.

We find it interesting to compare BREAD '19s to retail REITs as it offers 98bps-142bps pickup over FCT '19s, CAPITA '20s and SGREIT '21s. We find several similarities between BGL and retail REITs as they are dependent on retail sales and the biggest trade sector by revenue of retail REITs is typically from the F&B sector. In addition, BGL generates some rental income from its stakes in CHIJMES, AXA Tower and TripleOne Somerset. Although the remainder of BGL's assets are not properties, they are mainly tangibles (PPE and Cash). While BGL's gearing is somewhat higher than retail REITs, BGL's credit metrics are far healthier when assessed on the basis of net debt/EBITDA.

VI) Conclusion & Recommendation

BGL has moved beyond the high growth phase and has been consolidating its business by tightening costs controls and closing unprofitable stores. We are likely to see its credit profile continuing to improve with good cash flow generation and lower capex. As such, despite its small size (Market Cap: SGD283mn), **we initiate coverage of BGL with an issuer profile of Neutral**. With improving credit metrics and good cash flow generation, we have an **Overweight recommendation on BREAD '19s** as we see value in the short 2.4-year paper which provides a decent yield of 3.61%.

OCBC Bank

BreadTalk Group Ltd.

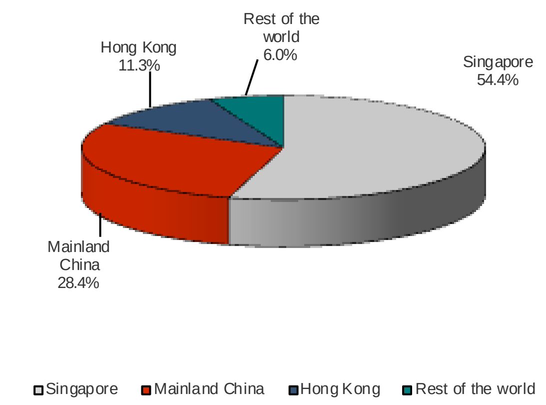
Table 1: Summary Financials

Year End 31st Dec	FY2014	FY2015	9M2016
Income Statement (SGD'mn)			
Revenue	589.6	624.1	461.7
EBITDA	52.6	61.2	34.6
EBIT	6.6	11.7	-2.0
Gross interest expense	3.7	5.3	4.6
Profit Before Tax	32.8	25.4	19.2
Net profit	22.1	7.6	7.0
Balance Sheet (SGD'mn)			
Cash and bank deposits	95.5	94.9	112.5
Total assets	538.8	545.1	528.0
Gross debt	198.5	202.4	192.4
Net debt	103.0	107.5	79.9
Shareholders' equity	138.5	146.4	146.1
Total capitalization	337.0	348.8	338.5
Net capitalization	241.5	254.0	226.0
Cash Flow (SGD'mn)			
Funds from operations (FFO)	68.1	57.1	43.6
* CFO	73.3	66.5	61.5
Capex	47.5	37.6	30.6
Acquisitions	45.8	22.9	2.8
Disposals	6.6	0.1	16.4
Dividend	6.2	7.8	8.0
Free Cash Flow (FCF)	25.8	28.9	30.9
* FCF adjusted	-19.5	-1.7	36.5
Key Ratios			
EBITDA margin (%)	8.9	9.8	7.5
Net margin (%)	3.8	1.2	1.5
Gross debt to EBITDA (x)	3.8	3.3	4.2
Net debt to EBITDA (x)	2.0	1.8	1.7
Gross Debt to Equity (x)	1.43	1.38	1.32
Net Debt to Equity (x)	0.74	0.73	0.55
Gross debt/total capitalisation (%)	58.9	58.0	56.8
Net debt/net capitalisation (%)	42.7	42.3	35.4
Cash/current borrowings (x)	1.2	1.2	3.7
EBITDA/Total Interest (x)	14.1	11.5	7.6

Source: Company, OCBC estimates

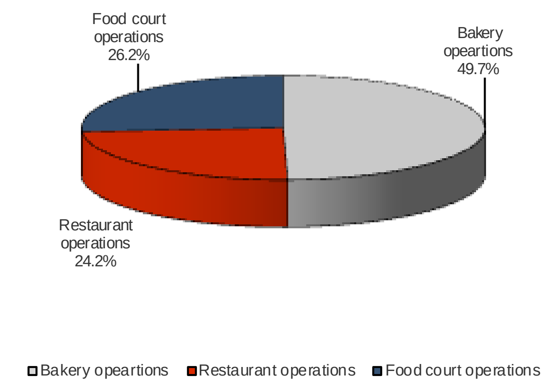
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO before deducting interest expense*

Figure 1: Revenue breakdown by Geography - 9M2016



Source: Company

Figure 2: Revenue breakdown by Segment - 9M2016



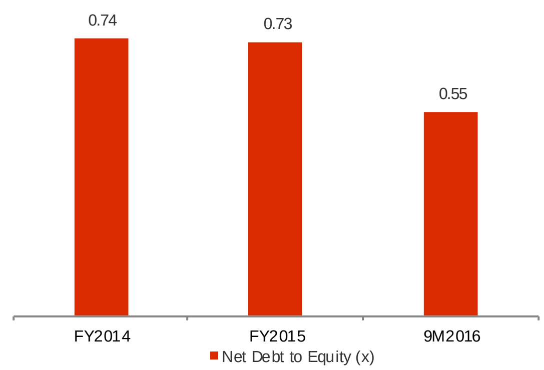
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 30/9/2016	% of debt
Amount repayable in one year or less, or on demand		
Secured	18.7	9.7%
Unsecured	11.6	6.0%
	30.2	**15.7%**
Amount repayable after a year		
Secured	77.1	40.1%
Unsecured	85.1	44.2%
	162.2	**84.3%**
Total	**192.4**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates