Asia Credit Research

OCBC Bank

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

Thursday, 27 June 2019

Issuer Profile: Negative (6)

Ticker: **CMACGM**

Background

CMA CGM, one of the largest container liners globally, acquired Neptune Orient Lines Ltd ("NOL") in June 2016. With that there are limited financial results on NOL and performance of CMA CGM (the parent) will be used as a proxy for NOL's performance. CMA CGM has not provided a corporate guarantee for NOL's existing bonds but as a material operating subsidiary of CMA CGM, NOL is likely to receive support from CMA CGM in our view.

Seow Zhi Qi
+65 6530 7348
zhiqiseow@ocbc.com

Recommendation

- Acquisition of CEVA Logistics ("CEVA") with largely debt has strained CMA CGM's credit metrics. Therefore, the pressure for CMA CGM to turnaround the CEVA business and reap synergies is on.
- Unexpectedly, CMA CGM has also indicated that it is looking to delist CEVA by end 2019, despite having previously guided to keep CEVA listed on the Swiss stock exchange with a significant free float in terms of share capital. This acquisition, along with CMA CGM's continued expansion of its fleet of vessels, translates to more committed use of funds down the road than we previously expected.
- Apart from International Maritime Organisation Low Sulphur Regulation in 2020 ("IMO 2020") mentioned previously, the operating environment for the shipping industry has weakened on prolonged trade tensions and a weaker global economic outlook which may impact trade as significant chunks of debt come due every year. This poses refinancing risk for the company.
- For the above reasons, we are **downgrading CMA CGM's Issuer Profile to Negative (6) from Neutral (5)** to reflect it's weaker than expected credit metrics and uncertain cash flow generating ability given business and industry factors even though it has a solid market position and continues to demonstrate access to funding.
- We are **neutral on NOLSP 4.65% '20s and NOLSP 4.4% '21s**, despite both bonds having widened 585bps and 809bps respectively since Jan 2019 on CMA CGM's evolving credit profile.

Relative Value

Bond	Maturity	Net gearing	Yield to Maturity	Spread
NOLSP 4.65% '20s	09/09/2020	319%	18.45%	1673bps
NOLSP 4.4% '21s	22/06/2021	319%	20.55%	1891bps

Source: Bloomberg, Indicative prices as at 27 June 2019
Net gearing based on latest financials

Background

- CMA CGM does business in a cyclical industry (international containerised transportation of goods, and logistics) and is vulnerable to the volatility of bunker fuel prices as well as global economic issues such as international trade tension.
- CMA CGM experiences seasonality. Demand for its services is typically higher in Q2 and Q3 of the calendar year for container shipping and Q3 and Q4 for the logistics segment. As such, Q1 is generally the weakest.
- As at 31 March 2019, CMA CGM operates 109 owned vessels and 166 vessels under IFRS 16 or equivalent agreements.
- MERIT Corporation, the parent company of CMA CGM holds a 70% ownership of CMA CGM while Yildirim owns 24% and Bpifrance (a joint venture investment bank of two public French entities) owns 6%.
- We have previously on 6 March 2019 downgraded CMA CGM following the release of its 2018 results and also highlighted CMA CGM's evolving credit in our Monthly report in April. Going forward, we will continue to closely monitor the performance of CMA CGM.

Key Considerations

- **Weak credit metrics**: Net gearing of CMA CGM stood at a high of 3.19x as at 31 March 2019 and at 1.61x if we were to reverse out the effects of IFRS 16 (2018: 1.41x, 2017: 1.25x). The higher leverage was largely due to the acquisition of CEVA. Eliminating IFRS 16 effects, we find interest coverage of CMA CGM and CEVA combined (including capitalised interest) at 2.06x. CMA CGM's standalone interest coverage was 1.65x while that for standalone CEVA was 3.51x in 1Q2019. EBIT generated in 3M2019 (USD252.9mn) was unable to cover its interest expenses on borrowings (USD321.7mn), though reported net consolidated loss (before tax) was lower y/y. The interest expenses on borrowings were higher, largely due to IFRS 16 application which has an impact on operating lease contracts. Excluding IFRS 16 effects, EBIT would have been USD188.3mn which is more than sufficient to cover both its adjusted interest expenses of USD169.4mn and capitalised interest of USD3.4mn.

- **Unexpectedly acquired 100% of CEVA:** Management at CMA CGM had earlier guided that it was committed to keep CEVA listed on the Swiss stock exchange with a significant free float in terms of share capital. Consequently, we had not expected CMA CGM to reach an ownership of 89.47% of CEVA shares as at 31 March 2019 and to reportedly hold 97.89% of CEVA's equity on 4 April 2019 and 99.4% as at 29 May 2019. In fact, CMA CGM is looking to delist CEVA by the end of 2019. If debt is used to fund the additional 10.53% in CEVA, CMA CGM's credit metrics will be under further pressure. Even though it is arguable that with a 100% stake in CEVA, CMA CGM may be able to integrate both businesses, turnaround CEVA and reap the benefits of the acquisition more quickly, we think it is premature to assign a value to these potential benefits at this point. We note that CEVA generated a loss of USD38.2mn in 1Q2019. Core EBIT margin for standalone CMA CGM (i.e. eliminating effects of IFRS 16 and CEVA) was 1.12% in 1Q2019 and 1.59% in 1Q2018, while that for CEVA was 1.13% in 1Q2019.

- **Fleet development continues:** Apart from acquiring CEVA, CMA CGM had on 25 March 2019 signed two strategic agreements with the China State Shipbuilding Corporation to purchase 10 15,000 TEU vessels (for USD1.1bn as per news sources) expected to be delivered by 2021. Five of these will be powered with LNG (to reduce carbon dioxide, sulphur, fine particles and nitrogen oxides emissions), while the remaining five vessels will be fitted with hybrid scrubbers (to eliminate sulphur and fine particles emissions). This is on top of its orderbook of 20 vessels for a commitment (net of prepayments) of USD1.49bn reported on 31 December 2018. We view this new purchase as a committed use of funds further down the road that exceeds our prior expectations, and can possibly push leverage of the firm higher should external funding be tapped to fund the purchase instead of internal cash.

- **Regulatory costs in sight:** The new International Maritime Organisation ("IMO") Low Sulphur Regulation of 0.5% global sulphur cap on fuel content will be effective from 1 January 2020 and CMA CGM has shared that this represents an estimated major additional cost of ~USD160 per Twenty-foot Equivalent Units ("TEU"). According to the consulting firm AlixPartners' 2019 Global Container Shipping Outlook, it was estimated that the IMO 2020 regulations could cost the container shipping industry as much as USD10bn globally, and that cost could increase significantly in 2020. Combined with a weaker operating environment for the shipping industry on prolonged trade tensions and a weaker global economic outlook that may impact global trade, earnings generation capacity for containers shippers is expected to be volatile, though the exact timing and extent remain difficult to foretell.

- **Cost reducing plan**: CMA CGM had in January 2019 announced a global plan to improve its operational performance with a cost savings objective of USD1.2bn in 2019. As at 29 May 2019, USD245mn savings (20.4% of USD1.2bn target) has already been achieved. This was through the rationalisation of some of the company's lines, greater operational efficiency, lower logistics costs, and new partnerships with its suppliers amongst others. CMA CGM is raising its savings targets to USD1.5bn, with the aim to achieve this mainly through streamlining its organisation and its maritime routes. We think that sharing of the tangible steps aimed to be taken would make investors more comfortable with the plan. Should the savings materialise, profitability at CMA CGM will look better. We will continue to monitor if these measures will come through given our expectation of weaker earnings generation capacity. This amplifies the importance of the cost reducing plan in translating to stronger cash flow and repayment ability.

- **Significant refinancing risk:** Even though CMA CGM has refinanced USD1.27bn of the current portion of its borrowings (28.5% of current borrowings), it still has another USD3.17bn coming due this year (USD1.74bn of which is lease liabilities under IFRS16). This is material for CMA CGM given its disclosed total liquidity (including undrawn committed credit facilities and securities and other financial assets but excluding forecast operating cashflow) of USD2.03bn as at 31 March 2019 is less than the balance amount the company has to refinance or repay this year. If we were to eliminate the application of IFRS 16, CMA CGM would have a liquidity of USD0.60bn in excess of its current borrowings, lower than previous years (2018: USD0.91bn, 2017: 1.38bn). Furthermore, CMA CGM has chunks of debt (excluding lease liabilities under IFRS 16) amounting to USD2.12bn coming due in 2020, USD1.82bn in 2021 and USD1.72bn from 2022 onwards. These sums are not small. Assuming its entire bank borrowings are secured against assets, the leftover assets for unsecured debtholders amounts to ~USD3.80bn (versus ~USD3.36bn of unsecured senior bonds outstanding as at 31 March 2019). As such, we think the liquidity situation looks somewhat tight and CMA CGM is likely to be faced with recurring refinancing needs. CMA CGM's ability to repay or refinance its debt is largely dependent on multiple factors such as bank support, access to financial markets, ability to integrate CEVA and reap financial benefits. This is also assuming that the market conditions for the shipping industry remains intact.

- **Positive net cash flow at CMA CGM**: CMA CGM generated positive net operating cash flow of USD0.71bn in 3M2019 (2018: USD1.2bn, 2017: USD1.59bn), and saw a cash inflow of USD330.6mn from the business combinations relating to CEVA, which brought about a net investing cash flow of USD47.5mn. During the quarter, CMA CGM also paid USD513.8mn for leases relating to IFRS 16 and took on USD137.0mn net borrowings and interest expenses. Operating net cash flow alone was more than sufficient to cover interest expenses of USD141.8mn in 3M2019.

- **Obtained facility for early redemption of CEVA and subsidiaries' borrowings following the change of control:** We take comfort that CMA CGM has obtained financing amounting to USD825mn for the borrowings that are subject to early redemption as a consequence of the change of control (should the clause be exercised). We think this demonstrates CMA CGM's ability to access funding and receive support from banks. Such access is crucial for CMA CGM. That said, we think there remains a possibility for the cost of borrowing to inch higher. Average interest rate (after adjusting for hedging, amortised cost and purchase price allocation) for its general corporate purposes which is largely made of up of bonds is 5.2%, while borrowings related to vessels is 7.0%. CMA CGM's bonds are currently fetching over 15% yield to worst in the market. Should borrowing costs climb for CMA CGM, we think it may in turn further strain its relevant credit metrics.

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 **Ezien Hoo, CFA** +65 6722 2215 EzienHoo@ocbc.com **Wong Hong Wei, CFA** +65 6722 2533 wonghongwei@ocbc.com **Seow Zhi Qi** +65 6530 7348 ZhiQiSeow@ocbc.com

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 financial interests in the above-mentioned issuer or company as at the time of the publication of this report.

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Co.Reg.no.:193200032W