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

Wednesday, 06 March 2019

Issuer Profile: Neutral (5)

Ticker: **CMACGM**

Background

CMA CGM ("CMA CGM"), the fourth largest container liner, 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. <u>CMA CGM has not provided a corporate guarantee for NOL's existing bonds</u> but as a material operating subsidiary of CMA CGM, NOL is likely to receive support from CMA CGM.

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Recommendation

- CMA CGM has obtained derivative instruments to secure a 50.6% ownership of CEVA Logistics AG ("CEVA") (including the 33% shares it already owns). This is a net negative, in our view. While the acquisition of CEVA may bring about synergies, business considerations are overshadowed by the financial impact with derivative instruments driving net gearing higher to around 164%, from 141% at end-2018.
- Concurrently, we expect net gearing to climb even higher with USD725mn loan facilities set aside to fund the tender offer concluding on 12 March 2019.
- With additional downside risks further down the road from the International Maritime Organisation ("IMO") Low Sulphur Regulation in 2020 which will increase costs and refinancing risks with USD3.2bn worth of debt coming due in 2021, we **<u>downgrade CMA CGM's Issuer Profile to Neutral (5) from Neutral (4)</u>**.
- With the downgrade in Issuer Profile rating, we downgrade our bond level recommendation on NOLSP 4.65% '20s and NOLSP 4.4% '21s to Neutral (from Overweight).

Relative Value:

Bond	Maturity	Net gearing	Yield to Maturity	Spread
NOLSP 4.65% '20s	**09/09/2020**	**141%**	**5.63%**	**364bps**
NOLSP 4.4% '21s	**22/06/2021**	**141%**	**6.98%**	**500 bps**

Source: Bloomberg, Indicative prices as at 6 March 2019
Net gearing based on latest financials

Key Considerations

- **Leverage expected to climb:** CMA CGM had in Dec-2015 communicated that it *intends to deleverage its balance sheet within 18 to 24 months through synergies and asset sales for an amount of at least USD1bn, with the aim to reduce the debt gearing ratio to below 0.8 times*. While it did divest assets as guided, its deleveraging fell short of its gearing target. Specifically, net gearing was 170% in 2016, lower in 2017 at 125% and rebounded to 141% in 2018. We had previously held CMA CGM's issuer profile at Neutral (4) due to its commitment to deleverage. Looking forward, we expect net gearing to continue to climb from 2018 levels, given CMA CGM has entered into additional derivative instruments to obtain 50.6% ownership of CEVA (including the 33% shares it already owns). On top of that, CMA CGM has an ongoing public tender offer to shareholders of CEVA for CHF30.00 cash per share. The tender offer will be financed through loan facilities up to USD725mn and the balance through own funds. Pro-forma net gearing is expected to rise to around 164% if debt is taken to finance the increase in stake to 50.6%, and up to around 175% at 100% tender acceptance level where CMA CGM will fully utilise the loan facilities and fork out an additional USD93.8mn cash to finance the balance.

- **Bunker prices dragged profitability**: In 2018, revenue grew 11.2% y/y to USD23.5bn from USD21.1bn a year ago, largely on the back of a 9.3% y/y increase in volumes carried by the Transpacific, India/Oceania and Africa lines. However, the sharp rise in bunker prices of 33% and costs such as handling, logistics and transportation expenses brought about a 17.5% y/y rise in operating expense to USD22.3bn, leaving CMA CGM with low profit. Consequentially, based on our calculation, gross profit margin fell to 18.2% from 23.5% and EBITDA margin halved compared to 2017 (2018: 4.9%, 2017: 10.0%). Reported net profit (before tax) was down 79.2% y/y to a mere USD167.7mn. Despite a stronger top line, the container liner segment remains very sensitive to bunker prices which had risen more than expected in 2018, and led to the plunge in profitability. While bunker prices fell in late 2018, it has since recovered albeit not fully. We expect bunker prices to trend between 2018 and 2017 levels going forward, as such margins may improve though remain below 2017 levels. With CMA CGM looking to increase its stake in CEVA, we looked into the margins at CEVA. EBITDA margin for 2018 was 2.7% and estimated to be around 3.5% after adjusting for negative one-off events, while that in 2017 was slightly better at 3.3%. This leads us to think that the acquisition is unlikely to directly or significantly drive improvement in margins in the short term, despite cost savings from synergies. Net-net, we think margins may remain somewhat flattish.

- **Weaker interest coverage**: EBITDA/Interest coverage was also lower y/y at 2.4x in 2018 versus 4.3x a year ago, due to 45.4% lower y/y EBITDA (before disposal of property and equipment and subsidiaries) while interest was somewhat stable. Should CEVA be consolidated, EBITDA/Interest coverage looks to dip lower to around 1.9x. Having said that, synergies could provide some support. As part of the public tender offer, CEVA is targeting revenue above USD9.0bn and an adjusted EBITDA of USD470-490mn in 2021 (over 3 years). This represents a 7% y/y growth in revenue and a 22-24% y/y gain in EBITDA, and translates to an EBITDA margin of around 5.2-5.4%. This could also elevate the combined EBITDA/Interest coverage.

- **Uneven debt maturity profile**: CMA CGM has debt amounting USD1.0bn coming due this year, just USD83mn in 2020 and a debt tower of USD3.2bn in 2021. While CMA CGM is most likely able to manage the debt maturing within 2019, we think the debt distribution looks chunky and the USD3.2bn maturing in 2021 could become a concern if not addressed ahead of time. We note that CMA CGM has USD1.4bn cash on hand as at 31 December 2018 and net operating cash flow was USD1.2bn in 2018. Including CEVA's debt, the maturity profile continues to look uneven.

- **Cost reduction plan**: Along with 2018 full year results, CMA CGM announced a plan to improve its operational performance with a cost savings objective of USD1.2bn. No further detail was provided, other than it aims to do so through the optimisation of lines and brands, and by further streamlining its processes. Sharing of the tangible steps aimed to be taken would possibly make investors more comfortable with the plan. Should the savings materialise, profitability at CMA CGM will look better.

- **Downside risks in sight:** To reduce the industry's environmental impact, 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. In light of this, CMA CGM will use 0.5% fuel oil for its fleet, LNG to power some of its future container ships (9 ships on order) and order several scrubbers (exhaust gas cleaning systems) for its ships. CMA CGM shared that all these measures represent an estimated major additional cost of ~USD160 per Twenty-foot Equivalent Units ("TEU"). While this regulation may accelerate the scrapping of old vessels that are less fuel efficient, thereby reducing supply and allowing larger players an opportunity to gain pricing power, we see this on balance as negative given higher costs. In addition, we also see further downside risks stemming from the rise in protectionism and trade tension. This is expected to weigh on global trade and possibly negatively impact the top line figures at shipping companies. This could possible render the cost reduction plan vital to offset additional costs from tighter regulation.

- **Positive cash flow at CMA CGM but negative at CEVA**: CMA CGM generated positive net operating cash flow of USD1.2bn in 2018 (2017: USD1.59bn). However, the cash outlay to raise its aggregate stake in CEVA to 32.9%, largely resulted in a free cash flow of just USD237mn. CEVA, on the other hand, saw negative net operating cash flow of USD168mn due to cash outflow from working capital relating to revenue growth, lower non-recourse factoring and accelerated payments. Free cash flow at CEVA in 2018 was negative USD247mn due to capex worth USD109mn. Should cost synergies not be realised, CEVA could potentially erode any positive cash flows at CMA CGM.

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

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