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Hyundai Heavy Industries: A rare bright spot among Korean shipbuilders

by Victor Liu

South Korea has long been the market leader in the shipbuilding industry. As of March 2015, it had 44.1% of global market share, followed by Japan with 30.4% and China with 24.4%. Despite having the leading market share, the nation's shipbuilding industry has been facing a lot of business headwinds. Since the global financial crisis in 2008, global shipbuilding demand has drastically decreased; furthermore, the relatively higher labor costs in Korea and the relatively strong Korean won against the yen and the yuan in the past few years have made Korean ships pricier than those of China and Japan.

To break through the business predicament and avoid direct price competition with their main rivals, Korea's shipbuilders ventured into offshore oil platforms in the hope of riding on the soaring oil price to earn higher margins. Unfortunately, the business strategy shift turned out to be a failure, as the unexpected oil price slump since H2 2014 has relentlessly hit the bottom lines of those shipyards as a result of canceled orders and delayed projects for offshore rigs. Korea's three largest shipbuilders, Hyundai Heavy Industries (HHI), Daewoo Shipbuilding & Marine Engineering (DSME) and Samsung Heavy Industries (SHI), piled up a combined loss of KRW 7.7tn in 2015. DSME, as the worst performer, suffered from severe financial distress and was bailed out in October 2015.

As Figure 1 reveals, the RMI-CRI aggregate 1-year Probability of Default (PD), a simple median of 6 Korea shipyards, reflects the poor performance of the nation's shipbuilding industry. The upward PD trend eventually stabilized when the quantitative easing policy and the restructuring commitment took effect in H2 2015. The Bank of Korea has kept the base rate unchanged at a record low since June 2015 to stimulate the Korean economy. Also, as required by the government, major Korean shipyards since the second half of last year have been pushing for corporate restructuring plans, including deep job cuts and sales of non-profitable businesses, to get over unfavorable business conditions.

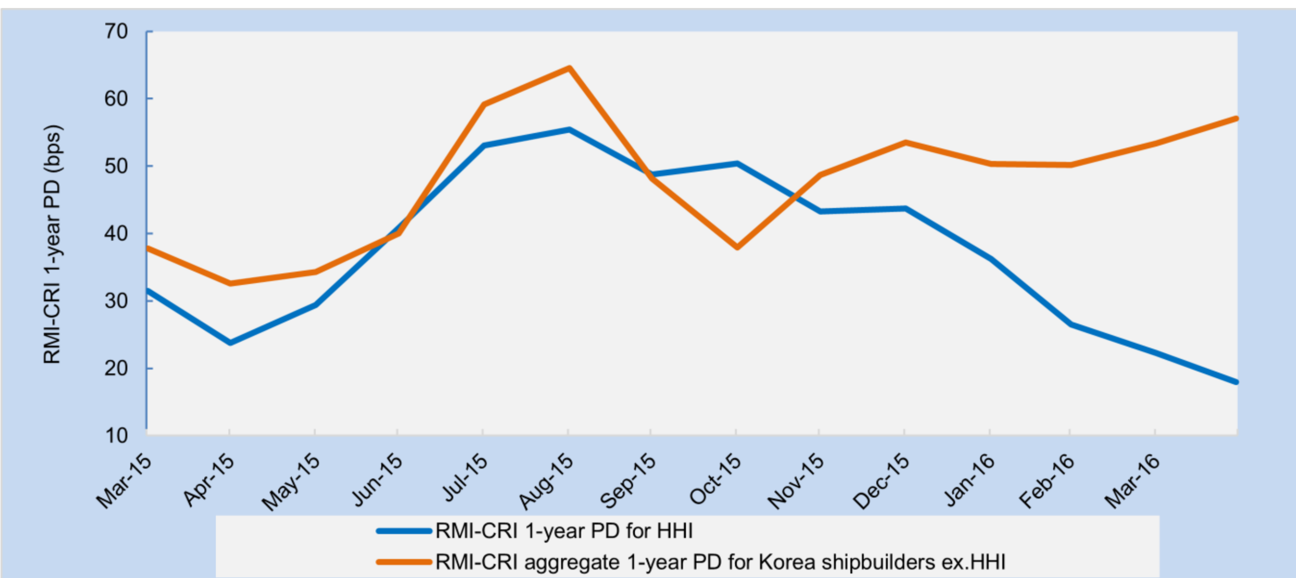

Figure 1: RMI-CRI 1-year PD for Hyundai Heavy Industries and aggregate PD for 6 Korea shipbuilders. *Source: RMI-CRI, Bloomberg*

It is noteworthy that while the RMI-CRI aggregate 1-year PD (simple median) for the sector remained at an elevated level in the wake of business restructuring, HHI's PD showed a significant improvement, resonating with its lower leverage, higher liquidity, and lower exposure to money-losing offshore engineering business than other major players, as shown in Table 1.

FY 2015	Hyundai Heavy Industries	Daewoo Shipbuilding & Marine Engineering	Samsung Heavy Industries
Total debt/ total asset	59%	98%	75%
Offshore engineering as % of revenue	12%	54%	70%
Total cash/ total asset	6.2%	5.5%	5.7%

Table 1: Leverage, liquidity ratio, and revenue contribution by offshore engineering business. *Source: Company data, Bloomberg*

The profitability figures for HHI also shed light on the cause for the PD improvement. The company stood out from its peers by reporting a quarterly profit after nine straight quarters of losses last Tuesday. As the sales revenue continued to decline by 7.8% QoQ and 16% YoY due to the falling new shipbuilding orders and backlog, the company attributed the profit turnaround to the operating margin improvement as seen in Table 2. The company conducted more high-margin non-shipbuilding businesses, such as construction equipment, engine and machinery manufacturing, and refining, while it limited its investment in the offshore engineering business, which had an operating margin of -7.7%.

KRW bn	2016 Q1	2015 Q4	2015 Q1
Sales revenue	10,273	11,139	12,228
Net profit	245	-378	-125
Operating margin	3.2%	-2.5%	-1.6%

Table 2: Profitability figures for Hyundai Heavy Industries. *Source: Company data, Bloomberg*

Although HHI became profitable again in Q1 2016, it is not until the global economy picks up and oil price recovers that Korea's shipbuilders will be able to ride out the industry storm. Currently, most of the industry players are still struggling with the legacy order books of the offshore drilling business and the lack of new shipbuilding orders. The good news is that last Tuesday, the South Korean Financial Services Commission published a sweeping three-part restructuring plan for the shipbuilding sector, one of the nation's flagship industries. The plan will require shipbuilders to cut their operating costs by laying off more people and selling loss-making assets, and thus probably give rise to disputes between the corporates and the labor union. While the worst time seems over, lots of challenges remain ahead for the industry.

Credit News

Brazil state banks' bond woes to worsen after years of largesse

May 3. Brazil's state-controlled banks may be in trouble after increasing lending in the past few years. Between 2012 and 2015, state banks boosted their lending by an average of 14.1% annually. As a result, Banco do Brasil SA, Caixa Economical Federal, and BNDES are seeing their borrowing costs in the bond market soar higher than those of private banks, as Brazil's long-term recession sparked a surge in delinquencies. (Business Times)

India's floundering bank debt-for-equity deals a warning for China

May 2. Indian lenders continue to struggle to find new owners for distressed steel and infrastructure companies that they took over under the Strategic Debt Restructuring swap plan, which was introduced by the Reserve Bank of India in 2015. The plan aims to reduce the level of bad corporate debt in India, by passing on the control of indebted companies to new owners within 18 months after the debt-for-equity exchange. The difficulties encountered by Indian banks will be monitored closely by China, where the government is also considering a similar plan after the non-performing loans in the banking system hit a 10-year high at the end of 2015. (Economic Times)

Puerto Rico's debt crisis deepens as government misses payment

May 2. Analysts are expecting more Puerto Rican corporate defaults after the Government Development Bank failed to pay USD 422mn of debt. With more than USD 2bn of loan repayments due in the coming months, the government is desperate to negotiate a deal with creditors to reach an agreement over future payments. The financial crisis in the commonwealth state could spread overseas as most of the island debt is held by institutional investors based outside of the island. Investors who were attracted to the high yielding bonds and tax benefits are now considering litigation action against each other in order to secure a claim on Puerto Rico's remaining reserves. (WSJ)

Aeropostale preparing to file for bankruptcy this week

May 2. Aeropostale is preparing to file Chapter 11 protection this week and close more than 100 stores, as the teen-apparel retailer faces mounting losses and declining sales. A number of mall-based specialty retailers have filed for bankruptcy in recent years as declining mall traffic, changing consumer tastes and competition from ‘fast fashion’ chains eat into their shares. Some 55% of US retailers that filed for bankruptcy since 2005 ended up going out of business, versus 5% in other industries.(WSJ)

Oil companies Ultra Petroleum, Midstates file for bankruptcy (WSJ)

Westpac bad debt rise spooks the market (The Sydney Morning Herald)

US banks sound caution on commercial property loans (FT)

Regulatory Updates

Bankruptcy code: panel suggestions may not adequately cover cross-border issues

May 3. Sources from the government of India expressed that the recommendations by the joint committee on the cross border aspects of default cases may not be adequate. In its report on the Insolvency and Bankruptcy Code, 2015, the joint committee had recommended the Indian government to enter into bilateral agreements to enforce the provisions of the Code and to issue a letter of request to foreign countries to seek information. Law practitioners believe that the impact from these suggestions will be limited as they are dependent on the strength of reciprocal agreements, as well as the willingness of the counterparty to share information. (Indian Express)

China financial regulator clamps down on shadow banking

May 2. During the past three years, banks in China have used complicated accounting techniques to move risky loans off the balance sheets into a category of investments that requires less provisions than loans. The move has also reduced the rate of defaults that appear on banks’ balance sheets because the assets no longer have the characteristics of loans. In response, China’s banking regulator is cracking down on financial engineering that those banks have used to disguise trillions of dollars in risky loans as investment products. (FT)

IRS rules could treat related party debt as stock

Apr 29. Lawyers say that proposed rules by the IRS to treat related party debt as equity could complicate tax planning procedures for multinationals. The US government is creating a new set of rules to curb inversions by domestic taxpayers to low tax foreign jurisdictions. The proposed rules would effectively treat debt as equity when they are issued in particular related-party situations or held by related parties not supported with specific documentation. The new regulations would require companies to keep extensive documentation for all related party debt and install new tracking parameters for compliance reasons. (Lexology)

ESMA publishes results of EU counterparties stress test

Apr 29. The European Securities and Market Authority (ESMA) has published the results of its first EU-wide stress test exercise regarding Central Counterparties (CCPs). ESMA’s stress test solely focused on the counterparty credit risk which CCPs would face as a result of multiple clearing member (CM) defaults and simultaneous market price shocks. ESMA tested the resilience of 17 European CCPs, which held over EUR 150bn worth of default resources with more than 900 CMs Union-wide. ESMA tested CCPs resources using combinations of CM default and market stress scenarios. The results show that CCPs’ resources were sufficient to cover losses resulting from the default of the top-2 EU-wide CM groups combined with historical and hypothetical market stress scenarios. However, under more severe stress scenarios, CCPs faced small amounts of total residual uncovered losses varying from EUR 0.1bn to 4bn. (ESMA)

Bank of Korea pledges active role in restructuring (Korean Times)

RBI clamps down on ‘working capital’ loans (Livemint)

ESMA amends MiFID II standards on non-equity transparency and position limits (ESMA)

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