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Weekly Credit Brief Jul 14 - Jul 20

Daewoo Shipbuilding is dragged by legacy order books

by Justin Hsiao

The shares of Deawoo Shipbuilding & Marine Engineering Co Ltd (Daewoo), the world's second largest shipbuilder, plunged by the daily limit of 30% on Wednesday last week after the local media reported that the company will book losses of KRW 2tn to 3tn from its offshore business and overseas subsidiaries. South Korea has the world's three largest shipyard companies in terms of order book - Hyundai Heavy Industries Co, Daewoo and Samsung Heavy Industries Co. These shipbuilders are shaken by the ballooning losses amid lower oil prices. Among them, Daewoo has suffered the most in this industry downturn because of its aggressive bidding and the huge losses in its offshore plants.

The RMI-CRI 1-year Probability of Default (PD) for Daewoo (shown in Figure 1) increased significantly to 216.17bps on Jul 15, 2015 from 107.56bps on the previous day. On Jul 17, 2015, Daewoo's PD of 255.05bps was much higher compared to its peers - Hyundai had a PD of 45.71bps and Samsung's PD was 44.68bps. Correspondingly, Daewoo's market cap has fallen by 57% this year, from KRW 3.6tn at the beginning of this year to KRW 1.5tn on Jul 17, 2015, making it the worst performing stock in the Kospi 200 Index.

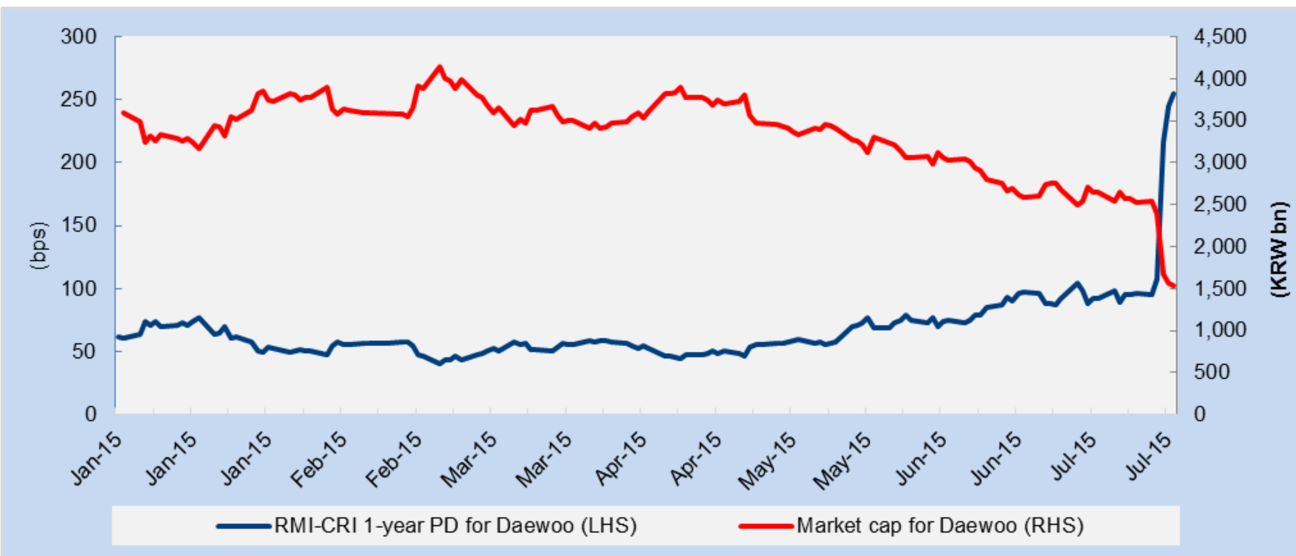

Figure 1: RMI-CRI 1-year PD and market cap for Daewoo. *Source: RMI-CRI, Bloomberg*

Daewoo's profit comes from two main sources: offshore plants and commercial vessels. The former is associated with oil production and drilling, and its corresponding products include offshore plants, drill ships, and semi-rigs etc. This segment, which accounted for 51% of the company's order backlog as of Jun 30, 2015 (shown in the left panel of Figure 2) suffered mightily as the international oil companies reduced their capital expenditure after the weakening of crude oil prices. Daewoo got only one order in this business segment in 2014.

After the financial crisis of 2008, the demand for ships declined substantially. Daewoo managed to improve its sales performance by bidding aggressively with discounts. However, the operating margin was adversely affected by this aggressive move (shown in the right panel of Figure 2). Besides, according to local media reports, Daewoo will book a loss of KRW 2tn to 3tn, mainly from the offshore plant contracts it previously signed. The company is widely expected to have a loss in the third consecutive quarter after the loss recognition. The company suffered huge losses from its 2011 orders to build four semi-submersible drilling rigs in the arctic region, each with a revenue of around KRW 600bn, but each schedule was delayed by an average of 10 months to a year. The delay in delivery means that Daewoo will have to pay for materials, labor and other expenses itself. Around 60% to 80% of the contracts for those offshore projects are paid on delivery; thus the delay will weigh on Daewoo's cash position. Moreover, the nosedive in oil price made some oil companies cancel their orders for drilling ships and other offshore facilities. These losses will further drain the cash position of the company, deteriorating its liquidity. Table 1 shows that the cash & cash equivalent of Daewoo has been in a decreasing trend.

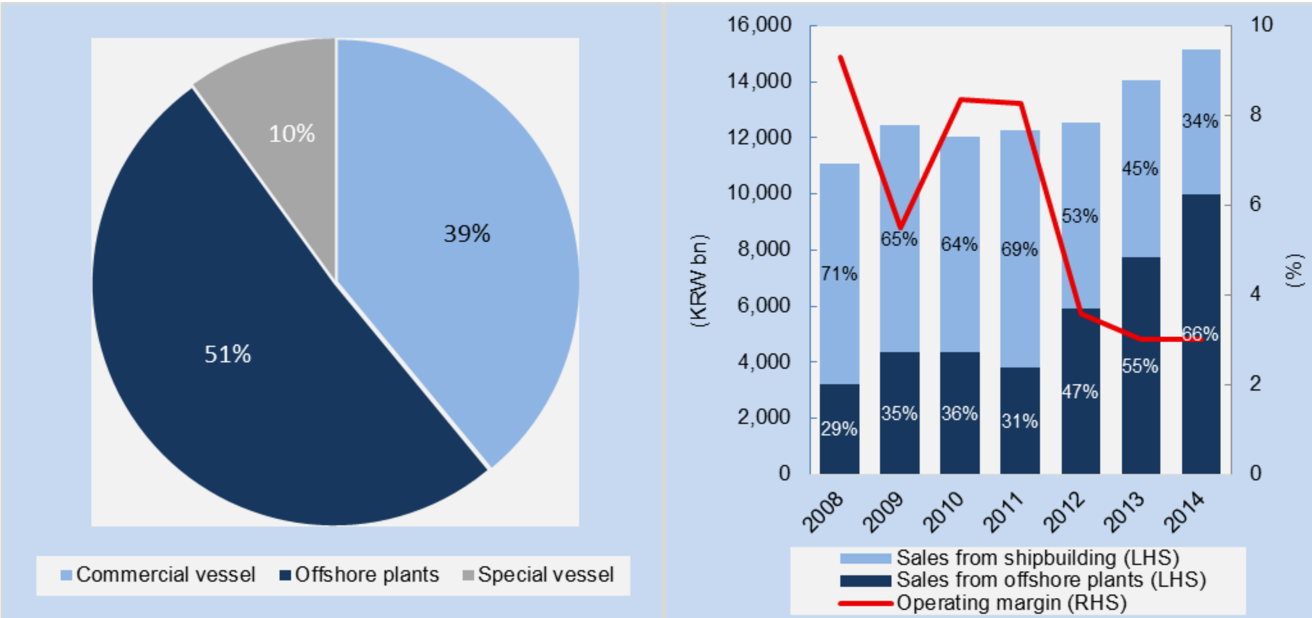

Figure 2: Backlog composition of Daewoo as of Jun 30, 2015 in the left panel; non-consolidated sales and operating margin of Daewoo in the right panel. *Source: Company's report, Bloomberg*

Daewoo has a KRW 200bn corporate bond that will reach maturity this Thursday, as well as another KRW 300bn which is set to mature in November. Some analysts have warned of liquidity problems at Daewoo given its high net debt to equity ratio (shown in Table 1), which was 156.53% at the end of last year and 182.41% in the first quarter of this year. The corporate bond yield of Daewoo has also increased significantly. The yield of the bond, which is going to be due next week, has increased from 2.35% to 2.81% after the plunge of the company's shares. Some local rating agencies, such as KIS Rating and Korea Ratings, have cut their ratings on Daewoo. The increase in corporate bond yield and the downgrades will increase the cost for Daewoo to raise funds from the capital market.

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015
Cash & near cash items (KRW bn)	238.0	121.1	132.4	106.6	87.9
Net income (KRW bn)	75.9	17.2	35.5	-16.5	-138.7
Net debt / equity (%)	145.44	161.20	156.38	156.53	182.41

Table 1: Financial figures of Daewoo. *Source: Bloomberg*

Korea Development Bank, a state-owned lender with a 31.46% stake in Daewoo, has pledged to normalize the company and started a large scale debt restructuring process. According to the lender, the restructuring measures could include sales of some overseas assets and domestic property holdings to improve the company's liquidity. On the other hand, Daewoo is getting some new orders from the shipbuilding segment, yet it is difficult to expect their profitability to improve due to smaller contribution to the sales from such segment and low ship prices. If the rebound of the oil price is not strong enough, the profitability of the company's offshore business would hardly recover. In the short term, the company will still suffer from its legacy order books in a low oil price environment.

Credit News

Banks warn that APRA move on home loan risks will push up mortgage costs

Jul 20. The Australian Prudential Regulation Authority (APRA) unveiled measures that will undermine mortgage profitability for the big four banks and Macquarie. These major banks will need to hold more capital against potential mortgage losses as the required average mortgage risk weight will jump from the current standard of around 16% to 25%. Analysts expect the banks to meet the new capital requirements through retained earnings and dividend reinvestment plans, under which shareholders swap all or part of their dividends for new stock. Banks might also ask shareholders to tip in more funds through capital raisings. APRA said it may lift the 25% floor further as the Basel Committee is expected to propose a new international framework on financial regulation later this year. (ABC)

UAE banks' asset quality on the rise

Jul 19. UAE banks showed a sustained improvement in asset quality in their first-half results with a consistent decline in non-performing loans (NPLs) and loan loss provisions, and an improved NPL coverage ratio. In addition, the results in the second quarter also reflect that banks have been strengthening their balance sheets with a strong deposit base for a cost-effective funding base in anticipation of the potential hike in interest rates in the US. Balance sheet indicators show an improvement of the overall asset quality as risk normalization is likely to occur in the second half of the year. (Gulf News)

China's biggest banks lend CNY 1.3tn in attempt to halt stock market meltdown

Jul 17. The Shanghai Composite Index began to plunge in mid-June, wiping RMB 24.8tn off stock values in a few weeks.17 commercial banks had provided RMB 1.3tn for the state-backed China Securities Finance (CSF) to halt a meltdown in Chinese shares. China Merchants Bank was the biggest financier in the latest move to shore up the market, lending RMB 186bn to the CSF. "It doesn't have to use up all the money, as long as it can make the rest of the market believe that it has enough ammunition," Hao Hong, a China strategist at Bocom International in Hong Kong said, and added that "for now, it seems to be working." (Guardian)

Swedish banks strain to cope with negative interest rate environment

Jul 16. Swedish banks are under pressure because of the negative interest rate environment. This is explicitly seen as Q2 earning reports by three large Swedish banks showed that the lenders continued to grapple with the burdens on deposits, though they may have improved in margins on loans. Given Swedish banks' struggle for deposits, they are cautious to charge large corporate and institutional clients for their deposits at the banks, despite the negative interest rate environment. Sweden has been living in an unconventional monetary landscape since February and the Swedish Central Bank's purpose to implement such policy is to prevent the Swedish Krona from appreciating against the euro. (WSJ)

Eurozone banks easing standard for loans (Marketwatch)

Putin signs bill on operation of credit rating agencies in Russia home (Interfax)

Regulatory Updates

Fed proposes tweaks to stress test rules for banks

Jul 18. The US Federal Reserve proposed a rule on July 17 to make changes to its annual exam of the financial health of the banks it oversees, the so-called stress tests. Banks that are subject to the supplementary leverage ratio would need to incorporate the ratio into their 2017 stress tests. The Fed also proposed that banks would continue to use standard models to measure risk on their books and would not be allowed to use models they have developed themselves. If adopted, the rules would take effect for next year's exam. (CNA)

Basel Committee says weak banks must be tackled early

Jul 16. In the light of the post-crisis development in financial markets and the regulatory landscape, the Basel Committee on Banking Supervision has updated its 2002 guidance on dealing with weak banks. According to the committee, supervisors dealing with distressed banks, whose liquidity is already impaired or is expected to be impaired soon, should intervene early and act promptly before problems become acute. The committee also identified potential causes for declining capital ratios which injure banks' solvency, including a rapid increase in risk-weighted assets, redemptions, typically of subordinated debt, operating losses and foreign-exchange rate movements. To ensure a timely improvement in their capital position, the committee also encouraged the establishment of incentives to pre-empt deterioration. (Bloomberg)

ESMA goes 'back to the drawing board' on bond transparency

Jul 16. The Chairman of Europe's securities watchdog claims that it will not be able to ensure perfection in trying to balance both transparency and liquidity in the bond market despite having considered the different ways. Market participants and policymakers are concerned that the thresholds for definition when a bond is subjected to transparency requirements are too loose and the requirement in the review of the markets in the Financial Instruments Directive might be detrimental to liquidity in the bond market. ESMA said that they went back to the drawing board to address these concerns but they were not able to find the ideal system which balances transparency and liquidity while satisfying the preferences of stakeholders. (eFinancial news)

EU watchdog to start next bank stress tests in Q1 2016

Jul 15. The European Banking Authority and European Central Bank will start to carry out stress tests for the EU's largest banks in Q1 of 2016. Next year's stress test is going to feature many aspects of the 2014 stress test, such as wide risk coverage to assess EU banks' solvency and static balance sheet assumption. The assessments of the banks are expected to be completed by Q3 of 2016 when banks' individual results will be released. The watchdog added that a separate transparency exercise towards the end of 2015 would be carried out where they will publish detailed information on banks' balance sheets, covering information such as leverage ratio, credit risk exposures, securitization exposures, to name a few. (Reuters)

Yellen open to easing small banks' burden (FT)

Bankruptcy amendment bill passed in Singapore (CNA)

Central banks likely to jump into China bond market (WSJ)

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