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Lippo Karawaci faces heightened credit risk

by Anastasia Tracy Kurniawan

Last week, Lippo Karawaci, Indonesian largest property developer by total assets and revenue reported its fifth consecutive quarter of negative operating cash flow in the first quarter of 2018. Net income, on a trailing twelve month (TTM) basis, plunged more than 30% from a year ago as the developer embarked on an ambitious USD 19.86bn investment to build Indonesia's futuristic town: Meikarta which increased Lippo Karawaci's credit and liquidity risk. The first quarter result reported a surging debt balance dominated by USD-denominated debts while revealing a depleting cash balance that may fail to meet its short-term obligations. In order to refinance its outstanding term loans and cover its short term obligations, Lippo Karawaci issued USD 75mn of senior unsecured 2020 notes on June 1, 2018.

As shown in Figure 1, the RMI-CRI 1-year Probability of Default (PD) for Lippo Karawaci and the aggregate 1-year PD for other 10 developers from the top 11 Indonesian developers have increased together with the USDIDR spot rate. The figure suggests that there is a positive correlation between the USDIDR spot rate and the Indonesian developers' 1-year PDs, with Lippo Karawaci having the highest positive correlation between Jan 2018 and June 2018. Other than the depreciating rupiah, Lippo Karawaci's deteriorating profitability with negative cash flows in last 5 quarters straight has further weakened the company's credit profile. Coinciding with the spike on Lippo Karawaci's PD in late April 2018, the 3 major credit rating agencies, namely Moody's, S&P, and Fitch Ratings have downgraded Lippo Karawaci's credit rating by 1 notch to B2, B- , and B respectively, all with negative outlooks.

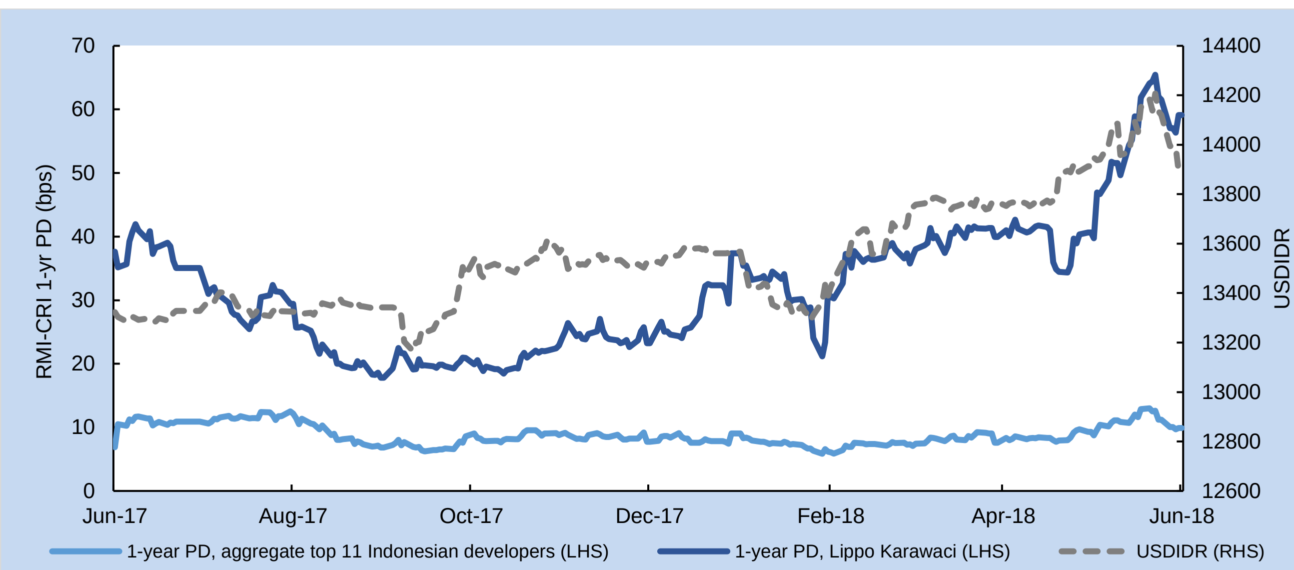

Figure 1: USDIDR vs RMI-CRI 1-year PD for Lippo Karawaci and 1-year aggregate PD for other top 11 Indonesian developers. *Source: RMI-CRI, Bloomberg*

The Rupiah's current weak position could aggravate Lippo Karawaci's debt woes. The currency recently breached 14,200 against the US dollar, which is the weakest position since December 2015. Among the top 12 Indonesian developers, Lippo Karawaci would be the most vulnerable to persistent rupiah weakness as it has the highest proportion of USD-denominated outstanding debt with more than 79% of its debt is denominated in the USD. The company's market capitalization plunged by 39.5% from USD 990mn on Jan 29, 2018 to USD 599mn on May 23, 2018 following a series of intense Rupiah depreciation. The low market value is a reflection of shareholders' concerns on the company's ability to meet its maturing foreign currency denominated obligation in a weak Rupiah environment.

	Total Debt/EBIT (X)			CFO/Total Liabilities (%)			Net Income Margin (%)		
	2016	2017	TTM	2016	2017	TTM	2016	2017	TTM
Lippo Karawaci Tbk	9.02	12.00	12.44	-1.52	-16.59	-17.12	8.21	5.63	5.56
Aggregate other top 11 Indonesian developers	3.60	2.13	2.81	5.57	10.02	21.03	18.73	28.64	31.35

Table 1: Financial positions of Lippo Karawaci Tbk and other top 11 Indonesian developers. TTM figures are based on all available company information between Q2 2017 and Q1 2018. *Source: Bloomberg.*

Fundamentally, Lippo Karawaci performed worse than other Indonesian top 11 property developers in terms of credit, liquidity, and profitability. Other than having the highest percentage of total borrowings over its cash flow, the company's operating cash flow has been falling. As of March 2018, the firm's USD cash reserves remains at USD 5.1mn but it has an upcoming coupon payment of USD 32mn and a principal of USD 50mn due in September 2018. With the Rupiah's current weak position, the foreign exchange translation from its IDR cash reserve may lead to a significant foreign exchange loss to meet the USD 76.9mn due. In addition, the USD 136mn equivalent reported in total cash balance may not be sufficient to meet its total short-term debt, which amounts to USD 154.7mn. With net income declining more than 30% YoY, it may imply a serious risk on Lippo Karawaci's operating cash flow to meet its short-term debt.

Over the last couple of years, Lippo Karawaci has been trying to mitigate the shortfall by selling assets like retail malls and hospitals to its listed REITs: First REIT and LMIRT in Singapore, making its cash flow reliant on asset sales. However, the regulatory leverage caps on Singapore REITs enacted mid-2015 has hindered Lippo Karawaci from selling assets to its REITs to raise cash. Furthermore, Lippo Karawaci's last quarter result reported only USD 669mn assets available for sales, which is only sufficient to cover its funding gap over the next 12 to 18 months. The situation is particularly acute because it has limited operating cash flows to service its interest payments and rent, barring planned asset sales.

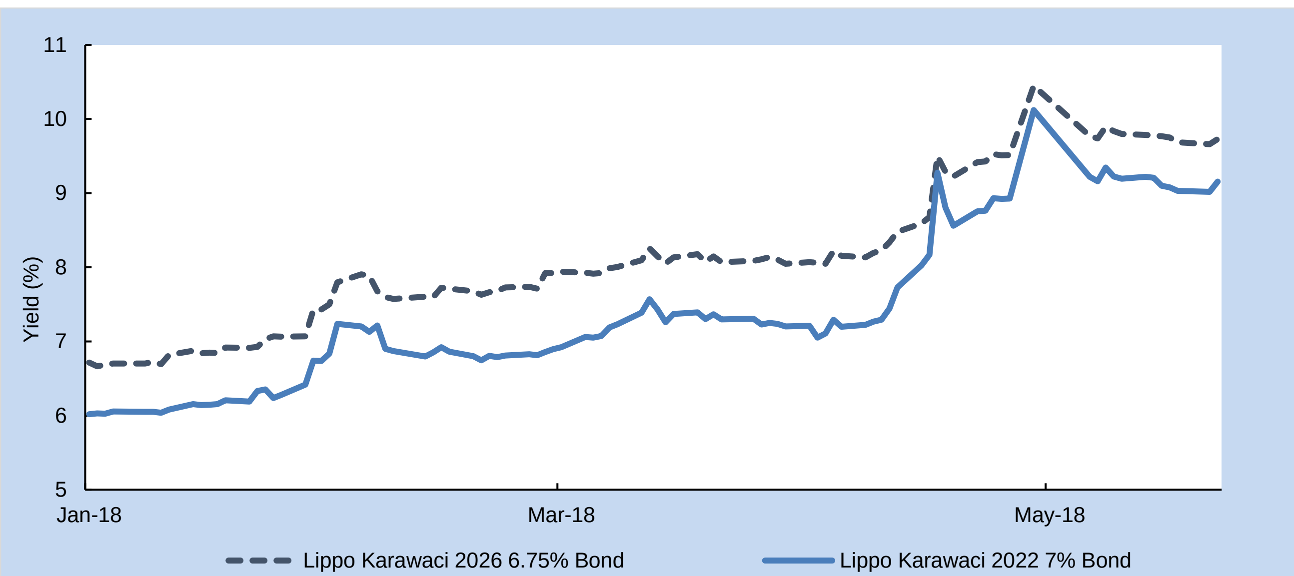

Figure 2: Bond yield of Lippo Karawaci's 2022 and 2026 bonds. *Source: Bloomberg.*

Concerns about Lippo Karawaci's ability to pay its coupon and principal have been reflected in the company's elevated bond yields. On April 2014 and October 2016, Lippo Karawaci issued 2 high yield bonds under its subsidiary, Theta Capital, to fund the redemption of its existing senior notes. The USD 410mn April 2022 note was priced at a yield of 7% while the USD 425mn November 2026 note was priced to yield 6.75%. This year, the yields of both notes reached as high as 10% as bond prices tumbled 6.7% and 13.8%, respectively.

Despite Meikarta apartments' successful sales in 2017, the Rupiah's depreciation could further decrease Lippo Karawaci's liquidity with a high debt burden and fast burning-cash-rate. Lippo Karawaci is threading on a fine line with another USD 75mn senior note issuance to meet half of its maturing debt redemption. Additionally, the recent credit rating downgrades might hinder Lippo Karawaci's ability to tap on another credit facility. As capital expenditures in the Meikarta project increase over the next 3 years, the ability of the company to meet its obligation remains dependent on asset sales and another debt issuance, which are dependent on market conditions.

Credit News

China bondholders set to find out how much a promise is worth

Jun 4. China's dollar-bond market is facing a test as China Energy Reserve & Chemicals Group Co. and CEFC Shanghai International Group Ltd, two issuers of debt with so-called keepwell provisions, have defaulted on their dollar notes in May this year. The keepwell provision is a credit-protection pledge almost only applied in China debt market that helps to maintain an issuer's solvency by offering pledges from the parent of an issuer alongside bonds to enhance their creditworthiness. According to Bloomberg, Chinese issuers have about USD 100bn of notes outstanding with keepwell agreements, which accounts for about 80% of such dollar issued bonds globally. As the prices on junk debt plunging to a three year low in May, a default in keepwell deed would hit China's dollar bond market further. (Bloomberg)

India's USD 210bn bad debt lures funds hunting for returns

Jun 4. The Insolvency and Bankruptcy Code introduced in 2016 has lured more offshore investors to buy the borrowers' distressed assets that value about USD 210bn. According to Baker McKenzie Wong & Leow in Singapore, foreign funds see great value in these problem assets and will bring in management and expertise to help the distressed companies. High potential profits on those deals attract lots of funds with sales of distressed assets from banks to third-party investors jumped in the year ended March 31, according to SC Lowy Financial in Hong Kong. In line with Prime Minister Narendra Modi's goal of getting rid of bad loans, Indian lenders are aiming to resolve about 40 of the largest troubled accounts with an outstanding debt of more than USD 60bn this year. (Bloomberg)

Ferrari and Ray-Ban deemed a safer bet than Italian government bonds

Jun 1. Italian government bond yields rose to its highest level in years as the country's eurosceptic politicians may potentially win a stronger hand in the upcoming election, raising the possibility of a eurozone break-up. The bonds of nearly two-third of non-financial companies listed in Italy have lower yields than that of the government bond. Some of the Italian multinationals such as Enel and ENI also carry higher credit ratings than the Italian government. Many of these companies benefit from their low exposure to the Italian market. Italy is currently ranked BBB by S&P's and Moody's has warned of a possible downgrade if the fiscal policies of the next government did not reduce the country's public debt on a more sustainable basis. (Reuters)

Online lenders tighten rules after a wave of defaults

May 30. Online-lending platforms have tightened credit rules and offer lower maturities to improve the loan quality that repackaged into asset-backed securities. The shift comes after a series of borrower defaults in the past three years that have triggered concerns among asset-backed securities investors. Meanwhile, facing a potential economic slowdown looming and rates rising, the move toward higher quality seems inevitable and urgent. According to Kroll, during last year the number of asset-backed securities issued by online lenders that saw performance triggers activated by missed payments declined, which implies am improved overall quality in the securities. (Bloomberg)

Greece relaxes capital controls to prove worst of turmoil is over

Jun 3. As confidence is gradually returning to Greece's banking system, the government doubled the amount depositors will be able to withdraw from their accounts in local banks from EUR 2300 to EUR 5000 a month. Business transactions with cash transfers abroad is also being doubled to EUR 40,000 a month. The easing of controls is an indication of the economy and country returning to normal amid Greece's debt relief negotiations with euro area creditors and the IMF. Even though Greek banks are plagued by high levels of non-performing loans, the non-performing exposures have dropped by 4.8% in Q4 2017, the highest quarterly reduction since the start of its crisis. (The Guardian)

S&P downgrades Deutsche Bank on restructuring plans (FT)

'Manufactured' credit default called off after legal challenge (FT)

New Zealand central bank says system sound but domestic debt is a risk (The Business Times)

Regulatory Updates

Israel central bank simplifies process for new banks in bid to spur sector

Jun 3. Israel has made it easier for companies to set up banks in the country as the top two lenders, Hapoalim and Leumi control 56 percent of the country's credit supply. The rules are part of the central bank's objective to encourage competition in the banking sector and lower borrowing costs for consumers. New banks will require to have an initial capital of ILS 50mn and maintain a Tier 1 capital ratio of 8 percent when total assets reach ILS 600mn. A new government unit will be set up to supervise new banks and guide applicants through the licensing process. (Reuters)

China's central bank expands collateral for mid-term lending

Jun 1. The People's Bank of China (PBOC) published a statement on June 1 states that it will broaden the range of collateral it accepts in its medium-term lending operations, add debt instruments tied to small-business funding and the green economy. The move would benefit smaller lenders with better access to central bank loans, meanwhile, making their bonds more attractive to investors. Previously, MLF collateral included treasury bills, central banks notes, policy banks bonds, local government bonds and corporate bonds with an AAA rating. The inclusion of loans in MLF collateral could also curb shadow banking and encourage on-balance-sheet financing. Giving Chinese lenders may have pressures on the maturing MLF lending due in the next few months, analysts think PBOC may cut reserve requirement ratio to give banks liquidity to pay back the debt. (Bloomberg)

Central Bank puts banks on notice they face capital buffer targets (Irish Times)

Kenya's central bank governor calls for regulation of fintech lenders (Reuters)

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