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Business headwinds dusted Dubai's largest construction firm

by Victor Liu

Arabtec Holding, the largest construction company in the United Arab Emirates, witnessed a stock price plunge last week followed by the preliminary earnings result of net loss for the fourth consecutive quarter and the announcement of another replacement of its CEO after the previous reappointment on June 2014. Figure 1 shows that the RMI-CRI 1-year Probability of Default (PD) for Arabtec has been climbing since May 2014 and reached a historical high at 206.92 on Nov 27, 2015, while the market cap had plummeted by more than 83% during the same period. The poor stock performance of Arabtec was mainly due to the operating challenges and the lack of transparency.

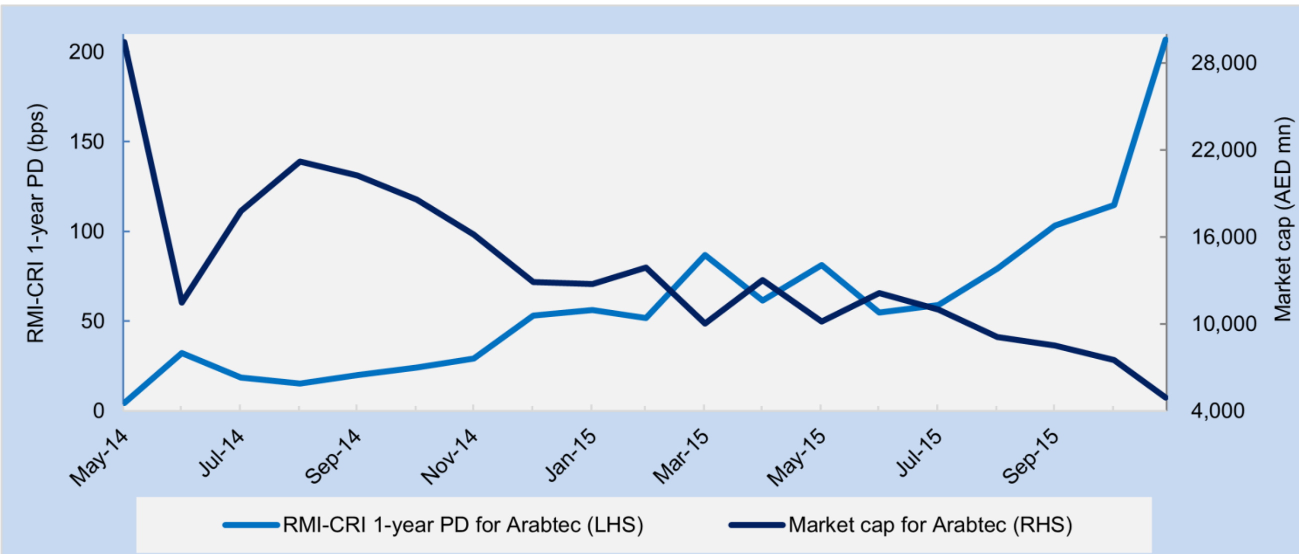

Figure 1: RMI-CRI 1-year PD and market cap for Arabtec Holding PJSC. *Source: RMI-CRI, Bloomberg*

The business environment has been disadvantageous to Arabtec for more than two years, as many land and building developments have stalled either because of funding problems or because of plan changes. Since the main property investors from Europe and Russia underweighted their investment in the Middle East after their currencies declined and the oil price started dropping from H2 2014, the six-nation Gulf Cooperation Council (GCC) held back their government spending on infrastructures. As a result, lots of project executions were delayed and the tendering activities slowed down in the GCC countries, hurting construction companies' sales revenues and gross margins. On Nov 11, 2015, Arabtec reported a net loss of AED 945mn for the third quarter, compared with a net profit of AED 69mn for the same period of 2014. The sales revenue dropped by 24% YoY and direct costs increased by 21% YoY in the third quarter, resulting in -38.5% gross margin versus 12.8% in 3Q 2014. The company attributed the net loss to the difficult regional construction market and a balanced approach to revenue recognition. It stated that it scaled back a number of challenging projects, including reversing AED 379mn of previously recognized claims and taking provisions of AED 136mn against receivables.

The lack of communication between investors is another key negative factor for the company's disappointing stock performance. Some analysts complained that Arabtec's management level of disclosure was insufficient. For example, the company never clearly explained why several senior executives, including the chairman, CEO and CFO, have left Arabtec in the recent 18 months; also, it never talked much about why the project of building 1mn houses in Egypt has failed, while the management declared in March 2015 that it was already in the final stage of the contract. The lack of transparency added to the investors' concerns especially in such an unfavorable macro environment.

In addition to Arabtec's stock price plunge, the breakdown of the return on equity ratio in Table 1 shows that Arabtec's shareholders have every reason for being worried about their investment. As all the three main components - profitability, asset efficiency and financial leverage - severely deteriorated, Arabtec's annualized ROE went down to -91% in Q3 2015 from 5% in Q3 2014.

(AED mn)		2014 Q3	2015 Q3
Profitability	Revenues	2403	1603
	Net Income	69	-945
	Net Profit Margin	3%	-59%
Asset Efficiency	Revenues	2403	1603
	Assets	13457	13493
	Asset Turnover	18%	12%
Financial Leverage	Assets	13457	13493
	Equity	6043	4134
	Asset/Equity	223%	326%
Annualized ROE		5%	-91%

Table 1: DuPont analysis for Arabtec Holding PJSC. *Source: Bloomberg*

On top of the poor ROE, the company also faces a serious liquidity problem. Table 2 indicates that the company will need to repay AED 1.3bn, which is almost 10% of its total assets, to banks within one year, while the quick ratio and interest coverage ratio have worsened.

	2014 Q3	2015 Q3
Bank Borrowings due in one year (AED mn)	1168	1331
Quick Ratio (x)	1.1	0.8
Interest Coverage Ratio (%)	6.2	-105.0

Table 2: Liquidity profile for Arabtec Holding PJSC. *Source: Bloomberg*

Despite the bad liquidity profile, some analysts think that the company could easily obtain required funding if necessary because Abu Dhabi state fund "Aabar" is the company's largest shareholder. Nevertheless, the lack of profitability and transparency is likely to discourage numerous investors and creditors from undertaking unnecessary risk by investing or lending to Arabtec. It is generally believed that the company could only regain its investment value when the business headwinds abate.

Credit News

Boost for China as it joins IMF elite

Nov 30. China has reached a significant milestone in its economic reform journey on Monday as the RMB will be included in the IMF's elite basket of reserve currencies. The RMB will hold a greater weight than the JPY or GBP in the new basket when it comes into effect in Oct 1, 2016. The USD will remain the biggest currency with a 41.37% weighting, followed by the euro with 30.93%. The RMB is slated to be the first emerging market currency to be included into the basket. (FT)

The USD 30 oil cliff threatening Russia's economy

Nov 30. Lower prices for crude oil are next year's biggest risk for Russia, which is unprepared to ride out another shock in the oil market. According to 63% of respondents in a Bloomberg survey, crude prices at USD 30 level will push the economy to depths that would threaten the nation's financial system. Other dangers for 2016 include geopolitical tensions, strains in the banking industry, and the weakening ruble. The Bank of Russia estimates that in a stress-case scenario, with crude below USD 40 in 2016-2018, the economy will contract 5% or more next year and price growth may be at 7-9%. That would raise risks to inflation and financial stability. (Bloomberg)

Glenn Stevens rate 'chill out' rattled as easing case builds

Nov 30. Just as it seemed Glenn Stevens's case for stable Australian interest rates was building, along came a fresh slump in iron ore, a drop in business investment and a currency rally. The Reserve Bank of Australia governor said last week traders should "chill out" until February, when policy makers will look at the data again. Policy makers appear keen to hold off cutting rates further to avoid reinvigorating the Sydney property market and hurting savers, even though the low inflation rate and high unemployment rate could be justified for another easing. (Bloomberg)

'Bad Bank' sees more Chinese debt souring as economy slows

Nov 24. China's slowing growth will prompt lenders to put more soured debt up for sale and lead to additional bad loans on banks' balance sheets, putting further strains on the country's financial system. According to China Orient Asset Management Corp, soured loans could make up 1.67% of Chinese bank-loan portfolios by the end of this year, the highest level in six years. It also added that bad loans could rise up to 1.94% of overall bank-loan portfolio by the end of 2016. (WSJ)

Corporate India suffers from a surfeit of debt

Nov 22. The USD 121mn debt default of Amtek Auto's, one of the largest integrated component manufacturers headquartered in India, has raised concerns about the high levels of debt in India companies. The illiquidity of India's corporate bond market has rendered this situation a cause for concern by asset management companies who were investing in Indian corporate bonds and related derivatives. This problem is not only present in India, as companies in other developed countries should also be aware about the liquidity risk in the corporate bond market. (FT)

Abengoa CEO Seage resigns after creditor protection request (Bloomberg)

China's shadow banking risk shifts to booming bond market (Reuters)

Noble Group's liquidity squeeze in the spotlight (FT)

Regulatory Updates

Fed says it's overhauling standards for large bank examiners

Nov 25. The Federal Reserve said that it will be setting more demanding standards for examiners of the largest US banks, following criticism by lawmakers on the quality of the Fed's oversight. The planned changes include creating a formal process for examiners to express dissenting views on oversight, such as whether lenders are complying with banking rules and appropriately responding to regulators' requests. Additionally, the Fed said that a centralized committee will oversee new minimum operating and documentation standards for all oversight activities, in order to make it easier for examiners to voice their findings. (Bloomberg)

Fed gives largest US banks extra year for debt rule calculation

Nov 25. The Federal Reserve said on Wednesday that larger US banks would be granted an additional year to calculate a capital requirement known as the supplementary leverage ratio for stress testing. Institutions subjected to the leverage ratio requirement will have to show regulators what the ratio would be in a stress scenario, starting from 2017. This capital requirement creates limits on how much debt banks can borrow relative to their assets, without giving banks credit for having relatively low-risk assets. Analysts said that this capital requirement creates distortion in the bond market, by making it more expensive for banks to fund positions in those markets. (Reuters)

China said to ease control on brokers' proprietary trading

Nov 24. China has scrapped off a rule requiring brokerages to hold daily net long positions in their proprietary trading accounts, following the stabilization of the nation's stock market after its summer slump. The China Securities Regulatory Commission (CSRC) has issued a notice indicating its relaxing of control over the brokerages proprietary accounts amid a gradual stabilization in equities. The CSRC will also allow the market to resume self-regulation and will resume routine monitoring of securities institutions. (Bloomberg)

China to probe largest brokerage for alleged rule violations (Bloomberg)

Stress test pressure may see UK banks cut dividends (Bloomberg)

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