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Tough times continue for Singapore oil rig builders

by Benjamin Lye

Sembcorp Marine Limited and Keppel Corporation Limited, two of the world's largest oil rig builders, have been facing a challenging time lately due to sluggish oil exploration activity and low oil prices. At $45 per barrel, exploration and production companies have little economic incentive to search and drill for oil. Customers have cut down on their capital expenditures and a wave of project cancellations have created a gloomy credit outlook for the two beleaguered oil rig builders.

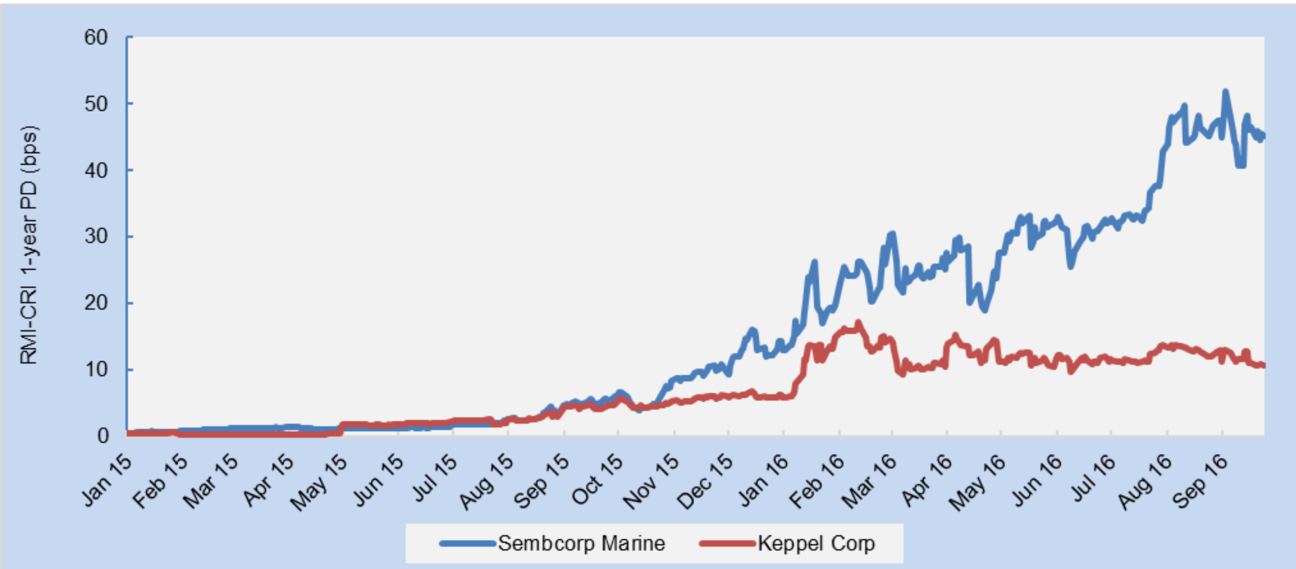

Figure 1: The RMI-CRI 1-year PD for Sembcorp Marine Ltd and Keppel Corp Ltd. *Source: RMI-CRI*

The RMI-CRI 1-year Probabilities of Default (PD) for Sembcorp Marine Limited and Keppel Corporation have been on an uptrend since mid-2015 (see Figure 1). The market capitalization of Sembcorp Marine and Keppel Corp have tumbled by 69% and 51% since June 30th, 2014. Although the credit quality of Keppel has stabilized this year, Sembcorp's credit quality has continued to worsen.

In Q2 2016, Sembcorp Marine's revenues dropped 24% while net profit declined by 90% YoY (see Figure 2). The firm attributed the poor performance to declining rig charter and utilization rates. Other contributing factors include foreign exchange losses due to revaluation of assets, higher financing costs, losses from associates and impairment charges.

On the other hand, Keppel's total net income decreased by 47% YoY to SGD 205.8mn in Q2 2016. Despite reporting lower earnings, Keppel's free cash flow improved in Q2 2016 and entered into positive territory for the first time since Q4 2014. Unlike Sembcorp Marine which focuses only on the marine and offshore engineering solutions, Keppel's business segment also covers property (which accounts for 29% of total revenue), infrastructure (25%) and investments (2%), alleviating the impact from a challenging oil and gas environment. As a result, despite a 64% decline YoY in the offshore and marine segment's net income, Keppel was able to cushion this fall from its other divisions.

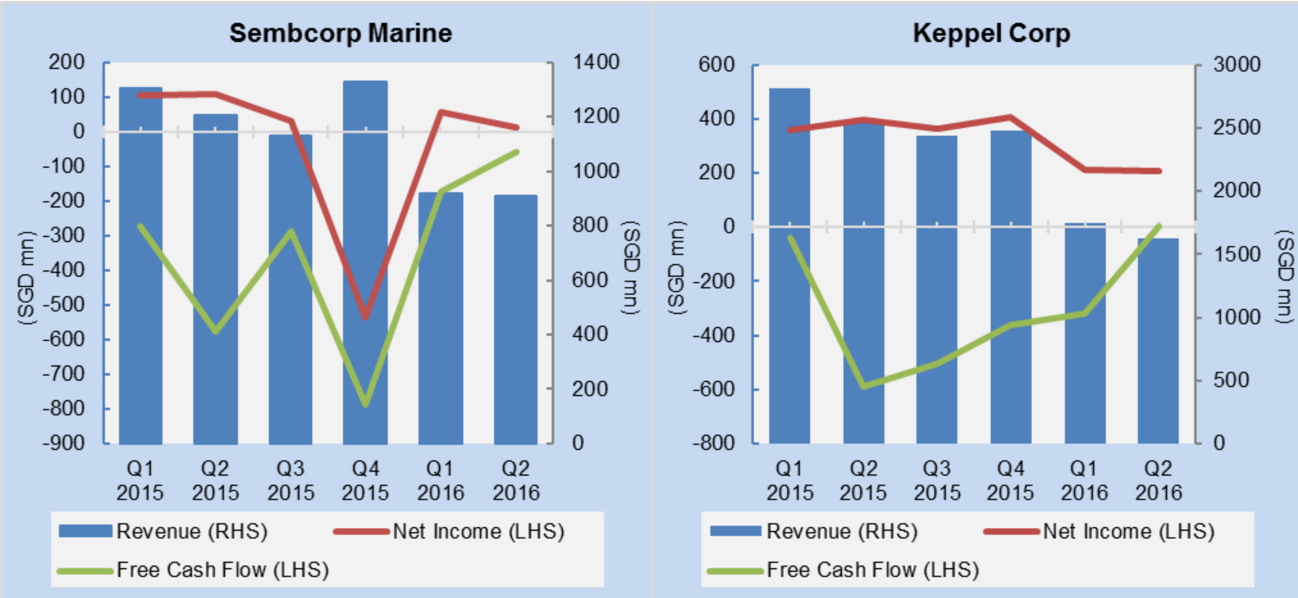

Figure 2: Revenue, net income (losses) and free cash flow for Sembcorp Marine (left panel) and Keppel Corp (right panel). *Source: Bloomberg*

Due to excess capacity, both firms have reduced capital spending and continue to downsize their operations. Sembcorp Marine is focusing on liquidity and balance sheet management. In order to maintain a healthy liquidity profile, Keppel is reducing its workforce and mothballing some facilities in its rig-building operations. Keppel expects lower working capital requirements moving forward but feels that its net gearing ratio of 62% is at a comfortable level.

The liquidity positions of both rig builders could be threatened if oil prices continue to remain low. Sembcorp Marine made a SGD 280mn provision in the last financial year for possible delay or cancellation of drilling rigs deliveries from clients. It is worth noting that the two rig builders were seriously impacted by the corporate failure of their major client, Sete Brasil, which filed for bankruptcy in April 2016 after failing to secure long-term financing. Sete Brasil accounted for SGD 10.5bn of orders from Sembcorp Marine and Keppel Corp. Sembcorp Marine set aside SGD 320mn (in addition to the SGD 280mn above) and Keppel set aside SGD 230mn in provisions in the last financial year due to exposures to Sete Brasil.

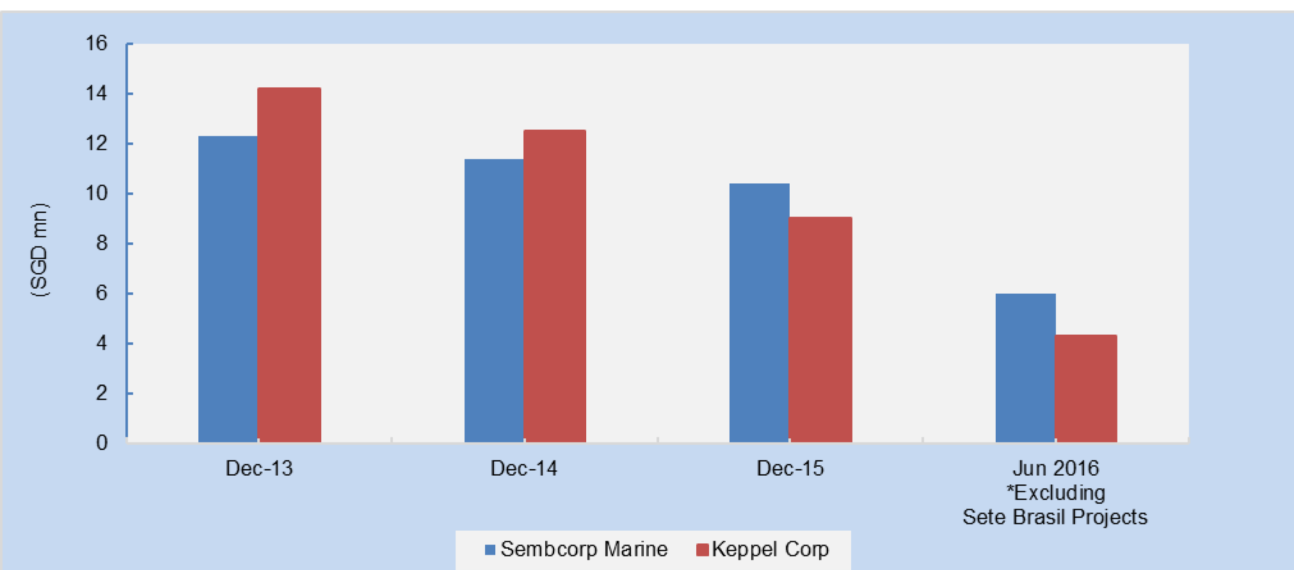

Figure 3: Net orderbook for the next 3-5 years (or more) at different financial reporting dates. *Source: Company report*

The sinking orderbook (Figure 3) for the two firms seems to suggest a prolonged challenging period for the two oil rig builders. This is especially so for Sembcorp as it has a relatively higher leverage ratio (1.47x) than Keppel (0.77x) in Q2 2016. Looking forward, Sembcorp Marine will focus on delivering from its order backlog, which has dropped to SGD 9.2bn (or SGD 6bn, excluding the Sete Brasil drillships), [from SGD 10.4bn at the end of last year](). Net order book at Keppel declined to about SGD 8.3bn (or SGD 4.3bn, excluding Sete Brasil projects) [from SGD 9bn at the end of December last year]().

Conditions in the offshore oil and gas sector are expected to remain challenging and low oil prices, declining day rates, weak demand, and oversupply of rigs have made replenishing the order books difficult. These could worsen project executions and create cancellation problems which, in turn, could threaten the liquidity position of the rig builders. Unless there is a turnaround in the global economic situation and in the oil sector's prospects, the two Singapore firms may continue to suffer.

Credit News

Turkey cut to junk as Moody's concludes its post-coup review

Sep 24. Credit rating agency Moody's cut Turkey's long term issuer and senior unsecured bond ratings to Ba1 from Baa3, citing lower economic growth and rising risks related to the country's external financing needs. The rating agency also said that the government's response to the unsuccessful coup raises concerns about the rule of law and effectiveness of government policy. The sovereign downgrade could deter foreign investors from investing in Turkey, which needs about USD 200bn every year to service its foreign currency debt and finance its current account deficit. (Bloomberg)

China starts default-swap trading as buffer against failures

Sep 23. The National Association of Financial Market Institutional Investors, a unit under the People's Bank of China released a statement about the central bank's approval of rules governing credit-default swap (CDS) trading in the nation's interbank market. Stated to aid in diversifying credit risks and to facilitate healthy development of the market, the swaps would increase the arsenal at Premier Li Keqiang's disposal as he seeks to get rid of zombie companies while preventing a wider market fallout. According to the head of Greater China credit research at Moody's Investors Service, "the launching of CDS trading shows the government may allow more bond defaults" and the "CDS will help investors mitigate the risk and alleviate market sentiment if investors face more defaults or suffer more losses after defaults." (Bloomberg)

Dongbei Special Steel Group forced into bankruptcy

Sep 23. According to an online creditor document, after defaulting on RMB 3.6bn and missing eight payments since March, Dongbei Special Steel Group was driven to bankruptcy. The company, which is China's largest specialty steel producer, was ascertained by the Liaoning provincial government as bankrupt, stating that "the bankruptcy plan is expected to come out by the end of September" and was demanded by the provincial government to complete the implementation of the plans in October. In the previous month, the company resisted pressure from its bondholders to file for bankruptcy. (Caixin)

UN warns next global recession may trigger sovereign debt default contagion (Sputnik News)

Contagion risks rise as China banks fund each others' loans (Bloomberg)

How Italy might turn piles of bad debt into assets for banks (Bloomberg)

Regulatory Updates

Russia says foreign banks need not apply to underwrite bonds

Sep 23. Russia announced that they no longer require the underwriting services of foreign banks after strong demand for the country's EUR 1.25bn bond pushed bond yields by nearly one percentage point to 3.82%. The bond was six times oversubscribed and the sale was managed without the help of traditional US brokers. Many large investment banks avoided the deal after warnings that the debt placement could violate international sanctions imposed on Russia two years ago. Demand for Russia's high yielding debt was so strong that the Finance Ministry is considering to boost international borrowing next year. (Bloomberg)

EU escalates standoff with US on global bank capital rules

Sep 23. Regulators in the EU and the US are unable to find a compromise on the use of capital floors, which caps the benefit a bank can gain by measuring risk using their own internal models. The EU is against the use of capital floors but the US says that discarding the capital floors allows the banks to game the rules. Banks have been using complex models for decades to price risky assets yet supervisors are suspicious that lenders have misused the models to understate risks and manage down their capital requirements. (Bloomberg)

Basel Committee publishes Basel III implementation assessment of Argentina and Korea

Sep 21. The Basel Committee on Banking Supervision had published reports assessing the implementation of the Basel risk-based capital framework and the Liquidity Coverage Ratio (LCR) for Argentina and Korea. The overall assessment outcomes for Argentina and Korea were positive and some aspects of the domestic rules in both counties are noted as more rigorous than required under the Basel framework. Specifically, Argentina's overall domestic implementation of the risk-based capital framework is found to be "compliant" with the Basel standards and is also assessed as 'compliant" with the Basel LCR standards. For Korea, overall domestic implementation of the risk-based capital framework is "largely compliant" while Korea is assessed as "compliant" with the Basel LCR standards. (BIS)

Ireland's central bank signals resistance to changing mortgage lending rules (Irish Times)

BOJ's new framework faces test as market to scrutinize bond operations (Reuters)

Bank of England is sounding the alarm on Chinese debt (Business Insider)

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