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Weekly Credit Brief Apr 18 - Apr 24

# Golden Agri-Resources burdened by high debt and disappointing earnings

By Kenny Liew

Despite posting a net profit of SGD 552mn in 2016, palm oil farmer and refiner Golden Agri-Resources Ltd is still a bane for market watchers. Its market capitalization has fallen 19% since the start of 2017, largely due to investor pessimism of the company's future earnings potential, and high relative levels of debt. Listed in Singapore, the company is a constituent of the FTSE Straits Times Index, despite having nearly all its plantations and refining operations in Indonesia.

The RMI-CRI 1 year probability of default (PD) for Golden Agri increased sharply on May 31, 2016 and in February 2017. Figure 1 (right panel) shows the sector's net debt/EBITDA ratios and 1-year PDs. Golden Agri's ratio of current assets over current liabilities has also been falling since Q1 2016. Compared to its peers, the company's cost structure is high. As a result, Golden Agri's operating margin fell to a mere 2.8% in Q4 2016. The operating margins at First Resources, Astra Agro Lestari and Sawit Sumbermas were 50.02%, 28.67% and 56.64%, respectively in Q4 2016.

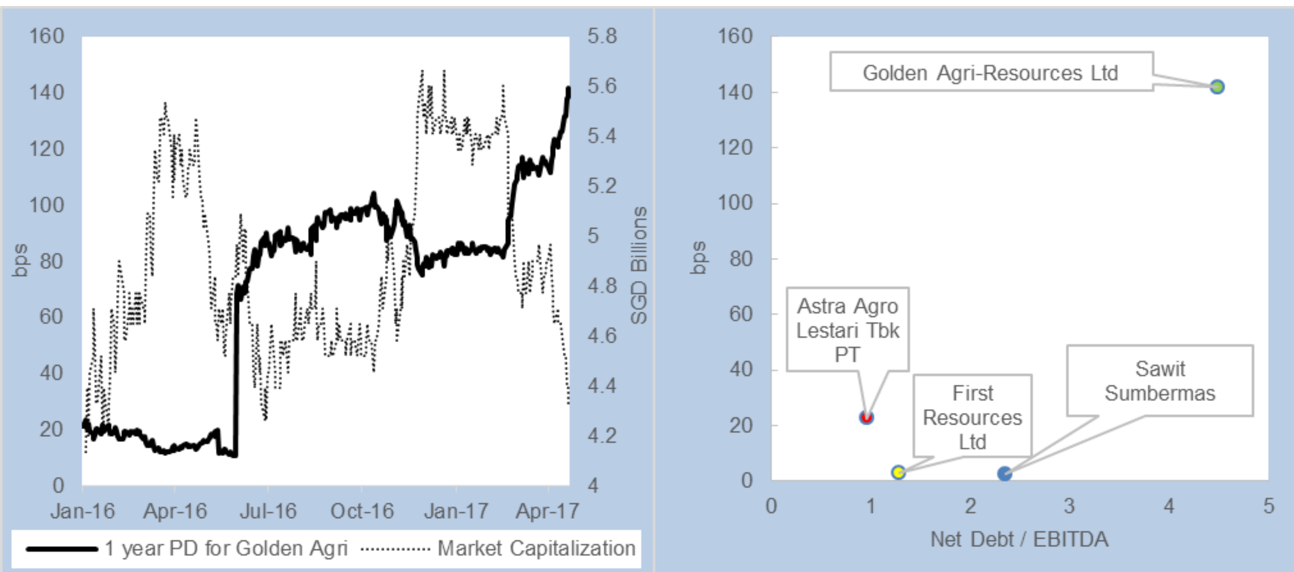


Figure 1: RMI-CRI 1-year PD for Golden Agri-Resources Ltd (left axis) and market capitalization (right axis) (left panel). RMI-CRI 1-year PD (as of 21 April 2017) versus Q4 2016 Net Debt/EBITDA ratio for Golden-Agri Resources Ltd and comparable peers[1] (right panel). *Source: RMI-CRI, Bloomberg*

With a significant portion of revenue derived from palm oil farming, the company's revenue stream is also highly susceptible to unusual weather changes. The El Nino droughts in 2015 had severely affected the output at its plantations. While some other palm oil companies had recovered quickly and some ruled out the possibility of the droughts affecting their output, Golden Agri's output has yet to fully recover. The output slump adds to the concerns about the age of the company's palm oil estates (15 years old on average), 96% of which are classified as mature. Older trees produce less fruit, threatening the company's output in the medium-term.

Several other factors in 2017 are driving investor pessimism. Palm oil prices, which closely mirror movements in soybean prices due to their substitutability, fell in the wake of a fall in Chinese soybean oil demand – driven by auctions of state rapeseed oil reserves and higher vegetable oil imports. Lower soybean oil prices shifted Chinese demand away from palm oil, which comprises over 70% of China's edible imports. Palm oil has lost over 18% since the start of the year resulting from the glut (see Figure 2).

[1] Golden-Agri's comparable peers are Indonesia-based palm oil producers and refiners with market capitalization exceeding USD 1bn.

A slump in crude oil prices also placed further pressure on biodiesel– of which palm oil is a key component. Biodiesel prices – using the EMI AFI B20 Biodiesel Index as proxy, dropped together with the slump in crude oil prices. When demand for biodiesel falls, demand for its palm oil component also drops, causing the price of crude palm oil to slump even further.

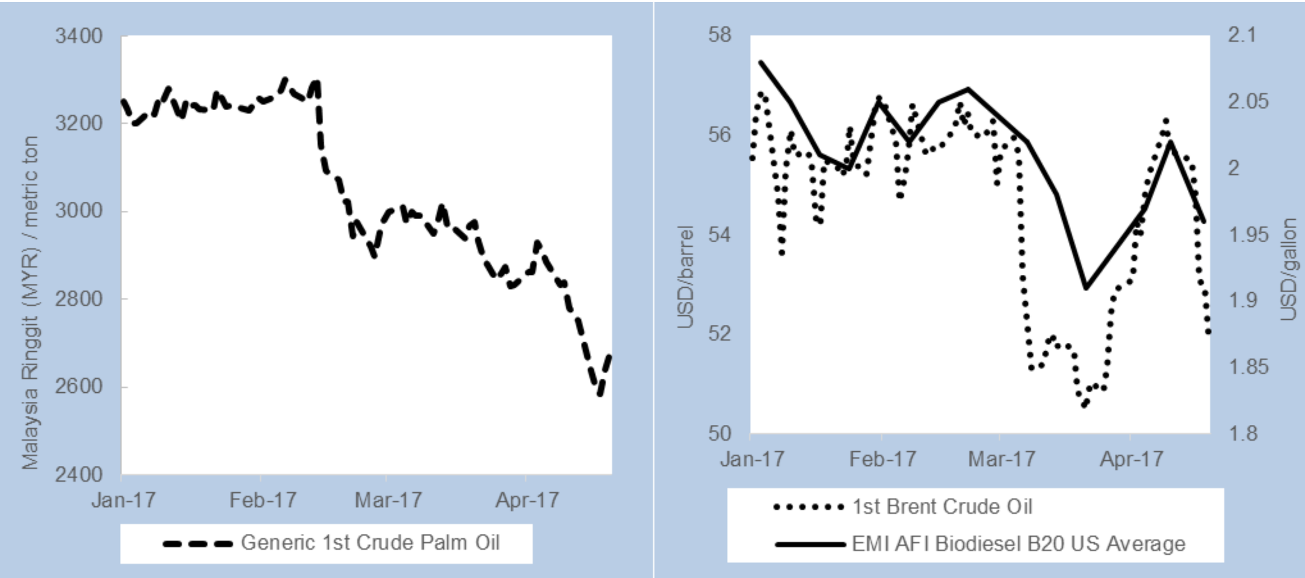


Figure 2: Generic Crude Palm Oil 1st month futures (left panel). Brent Crude Oil 1 month futures (left axis) and EMI AFI Biodiesel B20 US Average Index (right axis) (right panel). *Source: Bloomberg*

The outlook of the palm oil sector and the plantation industry remains negative. Analysts see strong palm oil production going into Q2 2017, with production in 2017 set to increase by 6 million tonnes – expected to put further pressure on crude palm oil prices. Indonesian 2017 exports of palm oil are also set to grow only marginally despite a boost in output, because of competition from other edible oils. On the flipside, the Indonesian government is targeting a 68% growth of crude palm oil use in biodiesel by 2020, to be driven by higher subsidies for blending – a welcome boost to palm oil players. However, a recent resolution passed by the European Parliament demanding the EU bloc to reduce use of unsustainably produced vegetable oils in biodiesel production in a bid to reduce deforestation could further dampen the industry's outlook.

While the company has 'continued focus' in enhancing margins across its value chain, in a highly volatile and competitive industry, Golden Agri must also manage its debt well and allocate even more resources to cut costs to be on par with other industry players, or it could very well remain in the sights of skeptics.

## Credit News

### UOB's new non-performing loans have peaked: CEO

**Apr 21.** UOB's Chief Executive Mr Wee Ee Cheong expects non-performing loans (NPLs) to peak for this year as shareholders raised questions related to NPLs and provisions during its annual general meeting. Mr Wee added that UOB's oil and gas exposure makes up only 5% of its total loan book and highlighted that provisions will be decreasing this year. UOB's chief risk officer also added that its stress test results have shown that UOB can still break even when asset prices dropped by 30% during a crisis. The quality of mortgage loans is also stable as 75% of it are for owner-occupied properties. UOB remains confident that it will be resilient despite volatility ahead as it has a strong robust balance sheet and it is focused on South-east Asia which has a strong growth potential. (Straits Times)

**Fitch cuts Italy's debt rating; cites weak growth, political risk**

**Apr 21.** Credit rating agency Fitch downgrade Italy's sovereign credit rating to 'BBB' from 'BBB+', citing political and fiscal problems with the country's government. Italy was placed on the agency's negative watch list in October following a series of fiscal deficits since 2013. Fitch expects Italy's government debt to continue rising after reaching 133% of gross domestic product last year. The elevated amount of non-performing loans in the Italian banking sector also adds to downside risks to the economy. (Reuters)

**Struggling apparel retailer Bebe to shut all stores**

**Apr 21.** Contemporary women's retailer Bebe Stores Inc. said it will close all its 180 retail stores by the end of May. It is a month after announcing it was exploring strategic alternatives following four years of losses. As a result of closing stores Bebe expects to recognize impairment charge of around USD 20mn, net of deferred rent and other credits which will be recorded in the third and fourth quarters. According to its annual report all the stores are leased and there is possibility Bebe could consider filing for bankruptcy to settle favorably with landlords of their stores. (Reuters)

**China's banking regulator warns trust firms of rising danger**

**Apr 20.** The China Banking Regulatory Commission (CBRC) has asked trust firms to tighten their risk management procedures, especially with regard to products related to property, coal and steel industries. The credit risk of these products may be higher than estimated as trusts firms had made illegal guarantees on principal and interest payments while withholding information from investors. The CBRC believes that some firms have been circumventing rules by providing illegal financing to real estate firms and warned the trust industry to improve disclosure and improve their product structure. (Reuters)

**IMF says debt binge leaves US corporate assets exposed**

**Apr 19.** The International Monetary Fund warned that US corporate assets are vulnerable to a sudden increase in interest rates and the ability of companies to cover interest payments is at its weakest since the 2008 financial crisis. US companies have added USD 7.8tn in debt and other liabilities since 2010 and by IMF's calculations, 22% of the total US corporate assets would be vulnerable if the US government's fiscal plan went wrong and led to a sharp rise in borrowing costs. The average interest coverage ratio has also fallen sharply over the past two years with earnings less than six times the cost of interest, a figure close to the weakest since the start of the 2008 financial crisis. The IMF also highlighted that 10% of the US corporate assets are unable to cover the cost of interest payments out of their current earnings. Many of these companies are found in the energy sector, suffering from the volatile oil prices in recent years, and increasingly, weak firms have emerged from other industries such as the real estate and utilities. (FT)

**Fujifilm delays earnings release after accounting irregularities** (FT)

**Malaysia and Abu Dhabi to settle dispute over 1MDB debt** (Straits Times)

**Regulatory Updates**

**Fine-tuning financial regulation for uncertain times: MAS MD**

**Apr 21.** The managing director of the Monetary Authority of Singapore, Mr Ravi Menon, highlighted that financial regulators have to be adaptable to changes happening in the financial industry. Mr Menon stressed that financial regulators have to continuously evaluate and fine-tune reforms to suit the changing environment. With new regulations continuing to grow, there has been increasing pressure to unwind some of the reforms due to increasing cost of risk management and compliance. However, Mr Menon warned about unwinding reforms in a drastic fashion that could limit the gains of financial stability. He added that the costs of compliance have to be weighed against its benefits to ensure a stable financial system to support growth and that is why fine-tuning reforms is necessary to reduce the unintended effects while preserving the benefits. Regulatory policies must be well implemented to discourage excessive risk-taking while encouraging innovation at the same time. (Today)

**China bank overseer launches 'regulatory windstorm'**

**Apr 19.** To implement the government's focus on managing financial risk, China's new chief banking regulator has started issuing a series of policy directives aimed at the industry's intractable problems. In the past 12 days, the China Banking Regulatory Commission (CBRC) has issued seven policy documents. The new policies mainly focus on shadow banking risks, especially high-yield investment products sold to retail investors and corporations. Small and mid-sized banks will be impacted most because they rely heavily on wealth management and interbank businesses. Analysts expect 2017 to be a big year for Chinese financial regulation as authorities become stricter and enforcements become more rigorous. (FT)

**China lifts renminbi capital controls as outflows pressure eases** (FT)

**China rolls out fresh tax cuts in bid to support economic growth** (Bloomberg)

**China policymakers bullish on economy, cite strong first-quarter GDP, stable yuan** (Reuters)

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