GUNKUL ENGINEERING PLC

No. 55/2018
27 April 2018

CORPORATES

Company Rating:	BBB
Issue Ratings:	
Senior unsecured	BBB-
Outlook:	Stable

Company Rating History:

Date	Rating	Outlook/Alert
11/04/17	BBB	Stable

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RATIONALE

TRIS Rating affirms the company rating of Gunkul Engineering PLC (GUNKUL) at "BBB" and also affirms the rating of GUNKUL's senior unsecured debentures at "BBB-". At the same time, TRIS Rating assigns the rating of "BBB-" to GUNKUL's proposed issue of up to Bt2,000 million in senior unsecured debentures. The one notch below the company rating reflects the ratio of the company's secured debt to total assets exceeding 20%, a threshold level under TRIS Rating's criteria. The proceeds from the new debentures will be used for working capital and debt repayment.

The ratings reflect GUNKUL's long track record of providing electrical equipment, vertical integration, experience in developing and operating power projects, and the predictable cash flows GUNKUL receives from the power segment. However, the ratings are constrained by the execution risks associated with the power projects and a looming rise in leverage.

KEY RATING CONSIDERATIONS

Long track record of providing electrical equipment

GUNKUL has long track record in its primary business of the trading and manufacture of electrical equipment. The company provides both public and private sector clients with an extensive range of products covering all stages of the transmission and distribution of electricity. The long track record and wide range of products have created a competitive edge, which results in fairly stable profitability in the electrical equipment segment. The gross margin of the electrical equipment segment has ranged from 22%-31% during the past five years.

Competitive strengths from vertical integration

GUNKUL expanded into the engineering, procurement, and construction (EPC) business and the power business in 2010. The moves put the company in a better competitive position as the primary business of the trading and manufacture of electrical equipment and the two new businesses are complementary in nature.

As an EPC power plant contractor and a supplier of electrical equipment, GUNKUL can provide one-stop service to project owners, which helps increase sales of electrical equipment, albeit indirectly. The company can also better control the construction costs of the power plants. GUNKUL's scope of construction work is limited as most of its construction contracts are turnkey projects for solar power plants in Thailand.

Experience in developing and operating power projects

GUNKUL has entered the power industry since 2010 when it developed 10 solar power projects, with a combined contracted capacity of about 57 megawatts (MW). These solar projects were operated by two wholly-owned subsidiaries and commenced operations during 2011-2013. GUNKUL later sold some of its stakes in the two subsidiaries, in pursuit of funds for further expansion in the power segment since 2012.

GUNKUL has placed a greater emphasis on rebuilding its portfolio of power plant projects. It has recently invested in many more solar power projects and embarked on wind power projects. As of March 2018, GUNKUL's aggregate equity capacity (or contracted capacity in proportion to its ownership stakes in the power plants), excluding the gas engine power project in Myanmar, was 488 megawatts equity (MWe), across 39 solar power projects (318 MWe), and five wind power projects (170 MWe).

Predictable cash flows from the power segment

The ratings are buoyed by the acceptable risks of the power segment, aided by predictable cash flows. GUNKUL's operating power plants have secured multi-year power purchase agreements (PPAs) with the state-owned electricity producer and distributors. Each PPA contains a committed tariff. The payment risk of the power buyers is minimal.

Performance has been satisfactory at the solar power plants which are operating. Since inception, the actual annual output of most solar plants has reached the initial estimates based on P50 (the energy production which is reached with a probability of 50%). Meanwhile, the output of wind power plants has reached the P75 level and the P90 level. GUNKUL's wind power projects started operations in 2016. Hence, their performances over the long haul have to be proven.

Execution risks associated with the power projects

GUNKUL has some sizable power projects under construction and in the development phase. One is the Mittraphap wind power plant in Nakorn Ratchasrima province, with a contracted capacity of 50 MWe. The project is scheduled to commence operation in the mid of 2018. Compared with a solar power project, a wind power project carries higher execution risks. Installation difficulties with the key components and higher construction risk can lead to cost overruns or project delays. However, GUNKUL has a satisfactory record of developing wind power projects. Its track record helps alleviate some concerns over execution risk.

In the absence of any large opportunities in the domestic market, GUNKUL has expanded to other countries. The company is developing four large-scale solar power projects in Japan and one project in Malaysia. The four solar power projects in Japan have a combined contracted capacity of 207 MWe. The first two projects, Sendai and Kimitsu, with a combined contracted capacity of 65 MWe, are scheduled to start operations in the last quarter of 2018. The other two projects, Utsunomiya and Iwakuni, with a combined contracted capacity of 142 MWe, are still in the development stage.

GUNKUL is exposed to construction risks. Two significant large projects, the Utsunomiya project and the Iwakuni project, will take about four years to develop and build. The long development period may result in unexpected costs and cost overruns, which could hurt the returns on the investments. However, the successful execution of each project will be a plus for the ratings.

The solar power project in Malaysia has a contracted capacity of 14.70 MWe. This project will cost about Bt1.35 billion, and it is developed by a joint venture between GUNKUL and a local partner. GUNKUL holds 49% in the joint venture company and the partner holds the rest. GUNKUL expects the project will commence operations by the end of 2019.

Revenue keeps growing

Revenue soared to a record high of Bt4.8 billion in 2017, up from about Bt3.2 billion in 2016. The jump in revenue was mainly propelled by the EPC segment and the power segment. TRIS Rating's base-case forecast assumes revenue will rise further, ranging between Bt5.5-Bt6 billion per annum over the next three years. The power segment will boost growth. The wind power and solar power projects, which are scheduled to start production during 2018-2020, will add 190 MWe in additional contracted capacity.

Revenue from the power segment will rocket to Bt2.5-Bt4 billion per annum during 2018-2020, up from about Bt1.5 billion in 2017. Sales of the electrical equipment will grow slightly to Bt1.2-Bt1.3 billion per annum, while revenue from the EPC segment will hover around Bt1-Bt2 billion per annum. The company had small backlog of about Bt2.1 billion as of December 2017. Most of the backlog will be realized as revenue in 2018.

Profitability to improve further

Profitability has increased recently. The operating margin (operating income before depreciation and amortization as a percentage of sales) increased remarkably to 30.7% in 2017, compared with the past levels of below 20%. The power segment, which carries higher returns, boosted profitability. The operating margin of the power segment was 80%-90% while those of the other business segments were 10%-20%. TRIS Rating expects the overall operating margin will increase to 40%-50% over the next three years, as the contribution from the power segment rises.

Leverage to continue rising and stay high

The ratings are weighed down by a debt-heavy structure. Most of the debts (about 60%) were project finance. The level of leverage has increased steadily since 2014 as the company has invested in many more power projects. Gearing is expected to rise further and stay elevated for the next several years. GUNKUL is forging ahead with plans to spend heavily on renewable power projects. It plans investments of Bt28 billion over the next five years. The four large-scale solar power projects, to be built in Japan, will cost GUNKUL to the tune of approximately Bt21 billion. These four projects will take long to come to fruition.

The investment expenditures outpace the cash generated by GUNKUL’s current portfolio of power plants. The company plans to finance the projects with long-term loans, which will keep leverage high. Moreover, the board of directors recently approved a share repurchase program, amounting up to Bt1 billion. The share repurchase will reduce its capital base. TRIS Rating’s base-case forecast assumes GUNKUL will repurchase about Bt500 million in stock. The total debt to capitalization ratio is projected to increase from 63% in 2017 to 74% over the next three years.

Cash flow protection has dropped recently, as leverage has risen. Looking forward, cash flow protection is expected to drop further due to imminent heavy spending on the renewable energy projects. However, cash from the new power projects will prevent a sharp fall in cash flow protection. GUNKUL’s total power production capacity is projected to double within the next three years. As a result, EBITDA (earnings before interest, tax, depreciation, and amortization) is projected to reach Bt3.5 billion by 2020, rising from about Bt1.8 billion in 2017. During 2018-2020, the EBITDA interest coverage ratio is expected to slide to 3 times, from 3.2 times in 2017. The ratio of funds from operations (FFO) to total debt will range from 5%-7%, compared with 6.8% in 2017.

Less room to meet financial covenants

A key financial covenant in GUNKUL’s debentures requires the net interest-bearing debt to equity ratio to stay below three times. GUNKUL was in compliance with this key financial covenant because the ratio at the end of 2017 was 1.63 times. However, the company has committed to make a number of large investments and it has committed to a share repurchase program. These two commitments will challenge GUNKUL to comply with the financial covenant. The share repurchase will also mean less of a cushion in the event of any financial distress. Based on TRIS Rating’s base-case forecast, the net interest-bearing debt to equity ratio is possible to reach 3 times in 2020. However, GUNKUL is expected to stay in compliance at least in the next 12-18 months.

GUNKUL’s liquidity is acceptable. As of December 2017, the total debts outstanding were about Bt16.7 billion. GUNKUL has debentures coming due worth about Bt280 million in 2018. The company plans to issue new debentures of up to Bt2 billion for working capital purpose and debt repayment. The new debentures will be used to replace outstanding bills of exchange (B/Es) worth Bt530 million as well.

RATING OUTLOOK

The “stable” outlook reflects TRIS Rating's expectation that GUNKUL’s solar and wind power plants will perform satisfactorily and generate the sizable cash flows as planned. GUNKUL is also expected to successfully execute the projects under construction and earn satisfactory returns. GUNKUL’s primary business as a supplier of electrical equipment is expected to remain on solid ground.

RATING SENSITIVITIES

A rating upgrade is unlikely in the near term but it could occur if GUNKUL’s operating performance and capital structure are significantly stronger than expectations. On the contrary, the ratings could be lower if the performance of the power projects falls short of the initial estimates or the respective guidance, or the capital structure deteriorates due to the failure to generate sufficient cash flows or aggressively debt-funded investments or cost overruns.

COMPANY OVERVIEW

GUNKUL was founded in 1982 by Mr. Gunkul Dhumrongpiyawut as a provider of electrical equipment. On the strengths of its core business, GUNKUL expanded into the EPC business and the power business in 2010. GUNKUL was listed on the Stock Exchange of Thailand (SET) in 2010. As of March 2018, the Dhumrongpiyawut family remained the major shareholder, holding approximately 54% of the company’s interest.

The company has an established market presence since it has been in the business for more than 30 years. The electrical equipment segment has accounted for the majority, or about half of GUNKUL’s total revenue, over the past five years, followed by the EPC segment (32%) and the power segment (14%). However, the power segment will become the centerpiece of GUNKUL’s revenue because GUNKUL is adding more capacity to generate power.

As of March 2018, GUNKUL’s aggregate equity capacity (or contracted capacity in proportion to its ownership stakes in the power plants) was 488 MWe, across 39 solar power projects (318 MWe), and five wind power projects (170 MWe). The power plants which are currently operating consist of 34 solar power projects (96 MWe) and four wind power projects (120 MWe). The remainder, or 272 MWe, comprises five solar power projects and one wind power project, which are in the construction and development stages.

KEY OPERTING PERFORMANCE

Table 1: Revenue Breakdown

	2013	2014	2015	2016	2017
Electrical equipment	64%	50%	85%	42%	25%
Construction	33%	47%	13%	28%	41%
Power projects	1%	1%	0%	27%	32%
Others	25%	2%	2%	3%	2%
Total	**100%**	**100%**	**100%**	**100%**	**100%**
Total revenue (Bt million)	**2,045**	**2,977**	**4,460**	**3,209**	**4,767**

Source: GUNKUL

Table 2: Power Project Portfolio

Company/Country	Hold by GUNKUL	No. of Projects	Gross Contracted Capacity (MW)	Equity Contracted Capacity (MWe)	Tariff
Solar Projects					
GPS	40%	4	26.0	10.4	Adder
GCPG	51%	6	30.9	15.8	Adder
RNS	67%	11	87.0	58.3	Fit
Japan	100%	4	207.0	207.0	Fit
Malaysia	49%	1	30.0	14.7	Fit
Others	-	13	20.5	11.4	Adder/Fit
Sub total - Solar	**-**	**39**	**401.4**	**317.6**	
Wind Projects					
WED	100%	3	60.0	60.0	Adder
GNP	100%	1	60.0	60.0	Adder
KWE	100%	1	50.0	50.0	Adder
Sub total - Wind	-	**5**	**170.0**	**170.0**	
Grand total	-	**44**		**487.6***	

* *Excluding the gas engine power project in Myanmar*

Source: GUNKUL

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Bt million

	---- Year Ended 31 December ----				
	2017	**2016**	**2015**	**2014**	**2013**
Revenue	4,767	3,209	4,460	2,977	2,045
Gross interest expense	569	330	116	58	47
Net income from operations	629	562	671	518	112
Funds from operations (FFO)	1,140	792	631	446	(87)
Earnings before interest, tax, depreciation, and amortization (EBITDA)	1,814	1,275	947	682	337
Capital expenditures	4,063	6,699	5,758	269	570
Total assets	30,377	25,596	18,815	7,239	4,580
Total debts	16,693	13,413	7,299	2,281	584
Shareholders' equity	9,803	9,749	8,590	3,360	3,121
Operating income before depreciation and amortization as % of sales	30.69	26.35	12.34	11.90	7.36
Pretax return on permanent capital (%)	5.41	5.18	8.46	14.02	6.87
EBITDA interest coverage (times)	3.19	3.87	8.17	11.78	7.10
FFO/total debt (%)	6.83	5.90	8.64	19.54	(14.96)
Total debt/capitalization (%)	63.00	57.91	45.94	40.44	15.75

* *Consolidated financial statements*

Gunkul Engineering PLC (GUNKUL)

Company Rating:	BBB
Issue Ratings:	
GUNKUL19OB: Bt1,265.50 million senior unsecured debentures due 2019	BBB-
Up to Bt2,000 million senior unsecured debentures due within 3 years	BBB-
Rating Outlook:	Stable

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