SAHAKOL EQUIPMENT PLC

No. 87/2020
22 June 2020

CORPORATES

Company Rating:	BBB-
Outlook:	Negative

Last Review Date: 21/06/19

Company Rating History:

Date	Rating	Outlook/Alert
08/06/18	BBB-	Stable

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RATIONALE

TRIS Rating affirms the company rating on Sahakol Equipment PLC (SQ) at "BBB-". At the same time, TRIS Rating revises the company's rating outlook to "negative" from "stable". The "negative" outlook reflects SQ's weaker-than-expected recovery of operating performance and concerns over the lingering high leverage level.

The rating continues to reflect the company's strengths in its core mining services and the predictable income streams SQ receives from long-term service contracts with creditworthy project owners. These strengths are offset by its narrow scope of business and intense business concentration risk as the company's performance hinges on a few large projects.

KEY RATING CONSIDERATIONS

Strengths in mining services

SQ's mining services primarily encompass overburden and lignite removal. The company's strengths in its core business have developed from its proven track record in mining operations, the wealth of experience of its mining engineers, and its fleet of specialized mining equipment.

Over the past three decades, SQ has served as the main contractor or a joint operator in mining operations for several phases of the Mae Moh mine. The company has repeatedly won long-term mining service contracts with the Electricity Generating Authority of Thailand (EGAT). EGAT's inclusion of SQ on its short list of technically qualified contractors reflects SQ's strong position in mining services.

As well as domestic projects, SQ holds a lignite mining service agreement with Hongsa Power Co., Ltd. (HPC), a leading power producer in the Lao People's Democratic Republic (Lao PDR). Despite the exposure to greater country risk, the project is viewed as a stepping stone to further growth opportunities outside Thailand.

Predictable income streams from long-term contracts

The rating recognizes the stable income streams SQ receives from long-term service contracts and the minimal credit risk of the project owners, EGAT and HPC. SQ has a fairly sizeable backlog, which helps secure its revenue in the medium term. As of March 2020, SQ's backlog stood at Bt26.4 billion. The projects in backlog comprise the soil and coal excavation project at Mae Moh Phase 8 (Bt15.6 billion), Hongsa mine (Bt8.5 billion), and operation and maintenance (O&M) services for a waste line system and ash conveyor system for HPC (Bt2.3 billion). The projects in the backlog are scheduled for completion in 2025 and 2026, respectively.

Intense business concentration risk

The company's strengths in its core business are largely held back by SQ's intense concentration risks and narrow scope of business. The Mae Moh mine has generated around 70%-85% of revenue over the past five years. SQ could be at high risk of failing to secure new contracts at the time the existing projects are closing out. Failure to outbid competitors could significantly jeopardize the company's revenue stream. The dearth of new viable mining projects in Thailand has forced SQ to seek opportunities abroad, exposing the company to higher country risk and counterparty risk.

Furthermore, the backlog contains only a few large projects. The largest project in the backlog is Mae Moh Phase 8, which accounts for 59% of the value of the backlog. Should SQ encounter any difficulties or underperform on any of its projects on hand, the company's overall financial profile would likely be affected.

Potential rise in exposure overseas

SQ and its Myanmar-based partner have set up a joint venture to undertake a 28-year coal mining concession in Shan State in the eastern region of Myanmar. The joint venture, which is 70% owned by SQ, is obtaining the rights from a state-owned enterprise of Myanmar to carry out mining work and subsequently construct coal-fired power plants. SQ expects long-term revenue streams from the coal mining operations and sales of coal. The joint venture is in the process of applying for the necessary permits.

In our view, the project is still far from materialization considering the slow-moving government bureaucracy of Myanmar. Furthermore, SQ will potentially load up on debt should the deal materialize as the company will need to spend Bt2.5 billion on the project. We view that such an investment amount is beyond the company's existing financial capability. Therefore, we believe SQ would need to raise capital to avert an overleveraged structure and breach of the bond covenant. We also have concerns over the high country and counterparty risks of the project. Given the lack of certainty, the project is not built into our base-case forecast.

Weaker-than-expected recovery of performance

We view that SQ has staged a slower-than-expected recovery in its performance. The company has heavily underperformed over the past two years, after experiencing hefty losses from a devastating landslide incident at the Mae Moh Phase 8 project. The landslide damaged parts of the conveyor system and equipment. The operating performance was worsened by cost overruns in the Mae Moh Phase 7 project. In effect, SQ's operating margin (operating income before depreciation and amortization as a percentage of revenues) fell to 25% in 2018, in contrast to 37%-40% during the three years earlier.

SQ's plan for a full recovery of operations in the Mae Moh Phase 8 project appears to have been delayed from the second quarter of 2019. As a result, the operating margin rose only to 33% in 2019 and 35% in the first quarter of 2020, which are lower than our expectation of 35%-40%.

Given the slower-than-expected recovery, we revise downward our projection of SQ's profitability. In our base case, we expect SQ to make about Bt4.2-Bt4.6 billion in revenue per annum during 2020-2022, with operating margin remaining around 35%. Given the high interest burden, funds from operations (FFO) are forecast to range from Bt1.0-Bt1.2 billion per year.

Debt-heavy capital structure

SQ has shouldered a heavy debt load to finance its higher working capital and capital expenditure needs. The ratio of debt to capitalization was high at around 78% in 2018-2019. The hefty increase in gearing came after investments in new equipment for the Mae Moh Phase 8 project, which cost SQ about Bt7.2 billion. Total debt stood at Bt7.5 billion as of March 2020. The debt to capitalization ratio remained high at 76.7% as of March 2020, in part owing to lower-than-expected cash flow from the Mae Moh Phase 7 and 8 projects.

We hold the view that SQ's financial leverage will stay elevated over the next three years. The debt to capitalization ratio is forecast to stay at 77% in 2020, before declining to 70%-74% in the following two years. Such a leverage level is considered high, notwithstanding the cash flow from work in progress. The ratio of FFO to debt is forecast to hold at about 15%, compared with the range of 15%-20% in our previous forecast.

Tightening liquidity and covenant headroom

SQ's liquidity is tight. The company had Bt182 million in cash at the end of March 2020 plus undrawn long-term project loans of about Bt115 million. At the same time, SQ has loans coming due over the next 12 months of about Bt2.4 billion, comprising Bt946 million in short-term loans and Bt1.5 billion in finance lease and project loans. The company will repay the project loans with the cash it earns from project progress payments. We expect SQ to generate FFO of around Bt1.0 billion over the next 12 months. As such, SQ is likely to rollover its short-term loans, most of which are bank loans.

With respect to the financial covenant stipulated in SQ's outstanding debentures, the company is obliged to keep the interest-bearing debt to equity ratio below 3.5 times. At the end of March 2020, this ratio was 3.32 times, suggesting tightened covenant headroom.

BASE-CASE ASSUMPTIONS

These are the key assumptions in TRIS Rating's base-case forecast for 2020-2022:

- SQ's revenue of around Bt4.2-Bt4.6 billion per annum.
- Operating margin to hold in the 30%-35% range.
- Capital expenditure of Bt1.7-Bt1.9 billion over the next three years.

RATING OUTLOOK

The "negative" outlook reflects our concerns over SQ's lower-than-expected operating performance. In the aftermath of the landslide incident, SQ's high leverage is likely to persist over the next few years. The company's performance is likely to remain under immense pressure with a very slim cushion.

RATING SENSITIVITIES

The rating could be downgraded if the operating performance continues to fall short of our expectations such that the operating margin stays below 35% and the ratio of FFO to debt falls below 15%. Pressure on the rating could also emerge in the event of a deluge of debt-financed investments which further deteriorate the company's financial profile.

Conversely, the outlook could be revised to "stable" if SQ's performance exhibits a substantial improvement in profitability and cash flow protection against debt obligations throughout the period of the current projects. This would happen if, for instance, the operating margin remained in the range of 35%-40% and the ratio of FFO to debt exceeded 20% on a sustained basis.

COMPANY OVERVIEW

SQ was established in May 2001 by the Sirison and Areekul families, but its roots date back to 1983. In that year, mining operations at the Mae Moh Phase 1 project were undertaken by Sahakol Engineer Co., Ltd., a predecessor company. SQ is currently the largest mining contractor in Thailand, providing a complete range of mining engineering services, including mine planning, open-pit mining operations, mining consultancy, and heavy-duty mining equipment rental and maintenance.

The company is primarily engaged in overburden and lignite removal services for the Mae Moh mine in Lampang province. The mine supplies lignite to the Mae Moh coal-fired power plants owned and operated by EGAT. SQ has conducted mining operations for several phases of the Mae Moh mine over the past 35 years. The projects at the Mae Moh mine have accounted for more than 70% of the company's total annual revenue over the past three years.

SQ went public in 2015 and was listed on the Stock Exchange of Thailand (SET) in October 2016. The Sirison family has been the company's major shareholder since its inception. As of May 2020, this founding family held a 24% stake in the company.

SQ's revenue has grown continually over the past few years after winning contracts for the Hongsa mine and the Mae Moh Phase 8 project. The latter is currently the largest project in the backlog. Revenue in 2019 was Bt4.8 billion, up from Bt3.6 billion in 2018. Revenue in the first quarter of 2020 was Bt1.3 million, up 5% from the same period last year. The EBITDA margin (earnings before interest, taxes, depreciation, and amortization as a percentage of revenues) held in the range of 37%-41% during 2015-2017. In 2018, the EBITDA margin dropped to 25%, but subsequently improved to 33% in 2019 and 35% in the first quarter of 2020.

KEY OPERATING PERFORMANCE

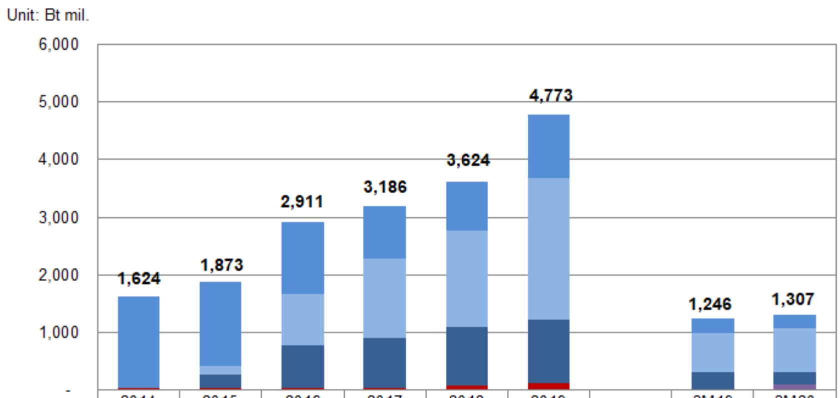
Table 1: SQ's Projects in the Backlog as of Mar 2020

Unit: Bt million

Projects	Duration	Backlog Value (Bt Million)	Total (%)
Mae Moh Phase 8	2016-2025	15,551	59
Hongsa mine	2015-2026	8,545	32
O&M Hongsa	2020-2026	2,265	9
Total		**26,361**	**100**

Source: SQ

Chart 1: Revenue Breakdown



	2014	2015	2016	2017	2018	2019		3M19	3M20
Mae Moh Phase 7	1,585	1,445	1,238	905	848	1,090		261	224
Mae Moh Phase 8	-	146	897	1,376	1,673	2,461		673	768
Hongsa	-	247	731	857	1,027	1,107		297	217
Hongsa O&M	-	-	-	-	-	-		-	81
Others	39	35	46	47	77	116		15	17

Source: SQ

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Bt million

	Jan-Mar 2020	--------------Year Ended 31 December 2019	2018	2017	2016 -----------
Total operating revenues	1,307	4,773	3,624	3,186	2,911
Earnings before interest and taxes (EBIT)	175	384	(123)	575	584
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	456	1,562	913	1,186	1,195
Funds from operations (FFO)	382	1,179	760	974	960
Adjusted interest expense	86	389	287	137	135
Capital expenditures	185	463	2,268	4,974	638
Total assets	11,115	11,106	11,987	10,241	6,004
Adjusted debt	7,388	7,544	7,639	4,727	1,544
Adjusted equity	2,270	2,165	2,166	2,578	2,251
Adjusted Ratios					
EBITDA margin (%)	34.90	32.74	25.18	37.22	41.04
Pretax return on permanent capital (%)	3.72 **	3.81	(1.37)	9.14	14.94
EBITDA interest coverage (times)	5.32	4.01	3.18	8.66	8.84
Debt to EBITDA (times)	4.82 **	4.83	8.37	3.99	1.29
FFO to debt (%)	15.87 **	15.63	9.95	20.60	62.20
Debt to capitalization (%)	76.49	77.70	77.91	64.71	40.68

* *Consolidated financial statements*
** *Annualized with trailing 12 months*

RELATED CRITERIA

- Rating Methodology – Corporate, 26 July 2019
- Key Financial Ratios and Adjustments, 5 September 2018

Sahakol Equipment PLC (SQ)

Company Rating:	BBB-
Rating Outlook:	Negative

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