SAHAKOL EQUIPMENT PLC

No. 92/2019
21 June 2019

CORPORATES

Company Rating: BBB-
Outlook: Stable

Last Review Date: 08/06/18

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-". The rating reflects the company's well-established core business as a leading mining contractor. The rating also reflects the predictable income streams SQ receives from long-term service contracts with creditworthy project owners and its sizeable project backlog. These strengths are partially offset by high leverage and business concentration risk, since a few large projects comprise most of SQ's revenue and profits.

KEY RATING CONSIDERATIONS

A leading mining contractor

SQ is a leading mining contractor, backed by a proven track record of running mines, plus the wealth of experience of its mining engineers and a fleet of specialized mining equipment.

SQ has conducted mining operations, primarily engaging in overburden and lignite removal services, for several phases of the Mae Moh mine for more than three decades. The company has repeatedly won long-term mining service contracts with the Electricity Generating Authority of Thailand (EGAT). In these contracts, SQ typically serves as the main contractor or a joint operator. EGAT includes SQ on its short list of technically qualified contractors, reflecting SQ's strong position in mining services.

SQ has sought to grow by expanding to neighboring countries. In 2014, the company entered into 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, these projects could be stepping stones to grow outside Thailand.

Predictable income streams and sizable backlog

In March 2019, SQ was awarded 7-year contracts by HPC for operation and maintenance services for waste line system and ash conveyor system. The contracts, worth Bt2.3 billion, left a sizeable backlog of Bt30.5 billion as of March 2019. In addition to these operation and maintenance (O&M) contracts, the projects contributing to the backlog comprise the soil and coal excavation project at Mae Moh Phase 7 worth Bt487 million, Mae Moh Phase 8 worth Bt18.1 billion, and Hongsa mine worth Bt9.6 billion.

The rating recognizes the stable income streams SQ receives from long-term service contracts and the minimal credit risk of the project owners. EGAT is SQ's principal customer, representing about 60% of the total backlog.

Business concentration risk

Despite the strengths in its core business, TRIS Rating views that SQ's business profile is moderate primarily because the company has such a narrow scope of business. As a result, the company carries business concentration risk. For example, projects affiliated with the Mae Moh mine made up around 70%-85% of revenue over the past five years. 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 the Mae Moh projects, there would be direct repercussions to the company's overall financial profile.

TRIS Rating also views that SQ's failure to win the Mae Moh Phase 9 contract in 2017 brought about a significant challenge to SQ with an absence of large opportunities in the domestic market over the next few years. In trying to sustain business growth, SQ will likely need to expand abroad. As a result, the company must contend with higher country risk and counterparty risk.

Severe impact from landslide incident and cost overrun

SQ's performance in 2018 fell short of TRIS Rating's previous forecast due in large part to larger-than-expected losses from the landslide incident at the Mae Moh Phase 8 project. In March 2018, SQ suffered from an unfortunate landslide at a dump site, owned by EGAT, adjacent to the project. The landslide damaged parts of the conveyor system and related equipment, as well as delaying the installation of a conveyor system.

TRIS Rating is of the opinion that the landslide was a one-off event. That said, the project recovery was much slower than TRIS Rating expected because of delayed installation and test runs of the conveyor system resulting from heavy rainfall in the area. As a result, the project operating costs soared, due largely to heavy use of dump trucks. SQ will receive Bt49.5 million in total from the EGAT as a compensation for the landslide incident. However, TRIS Rating views the remedy is considered minimal.

SQ's operating performance in 2018 was also dragged down by a hefty cost overrun in the Mae Moh Phase 7 project. In all, SQ's operating margin (operating income before depreciation and amortization as a percentage of revenue) fell markedly to 25%, down from 37%-41% during the three years earlier. SQ reported a net loss of Bt285 million in 2018. Funds from operations (FFO) declined to Bt760 million, down from nearly Bt1 billion a year ago.

Performance is expected to recover

SQ started to improve in the first quarter of 2019, aided by higher utilization of the conveyor system at the Mae Moh Phase 8 project and deployment of new equipment at the Hongsa mine. Meanwhile, the operation at the Mae Moh Phase 7 project remained mired, given the high maintenance cost of aging equipment. In all, SQ's operating margin bounced back to 38% in the first quarter of 2019.

TRIS Rating believes that SQ's operating performance will steadily recover once the conveyor system at the Mae Moh Phase 8 project is fully operational. Given the current backlog, TRIS Rating expects SQ will arrive at about Bt4-Bt4.5 billion in revenue per annum during 2019-2021. Operating margin will range between 35%-40%. FFO will rise to Bt1.0-Bt1.2 billion per year.

Lingering high level of leverage

The credit rating of SQ is largely weighed down by a high leverage level. SQ has shouldered a heavier debt load over the past two years to finance higher working capital and capital expenditures. SQ typically buys new machinery and equipment at the beginning of a new project. Total debt rose to Bt8.0 billion as of 2018, up from Bt5.2 billion as of 2017 and Bt2.5 billion as of 2016. The debt to capitalization ratio steeply climbed to 78% as of 2018, up from 41% as of 2016. The hefty increase in gearing was primarily caused by the investments in new equipment for the Mae Moh Phase 8 project, which cost SQ about Bt7.2 billion. Total debt stood at Bt7.7 billion as of March 2019.

TRIS Rating holds the view that SQ's financial leverage would stay elevated over the next few years, in part owing to lower-than-expected cash flow from the Mah Moh Phase 7 and 8 projects. The debt to capitalization ratio is forecast to remain high at 70%-77% during 2019-2021. The FFO to debt ratio is expected to hover around 15%-20%, while the earnings before interest, taxes, depreciation, and amortization (EBITDA) interest coverage ratio is expected to stay above 3.5 times.

Tightening liquidity and covenant headroom

SQ's liquidity is tight. The company had Bt201 million in cash at the end of March 2019 plus undrawn credit lines of about Bt48 million. TRIS Rating forecasts SQ will generate FFO of around Bt1.0 billion over the next 12 months. The company has loans coming due over the next 12 months of about Bt2.4 billion, comprising Bt941 million in short-term loans and Bt1.4 billion in project loans. The company will repay the project loans with the cash it earns from project progress payments. In recognition of this, SQ will need to roll over most of its short-term loans, most of which are bank loans.

Regarding 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 from 2019 onwards. TRIS Rating is of the view that SQ's recent underperformances in the Mah Moh Phase 7 and 8 projects leave the company with tightened covenant headroom to cushion in case of distressed event. However, TRIS Rating expects that SQ will resume good performance in its projects and abide by the financial covenants.

BASE-CASE ASSUMPTIONS

- SQ's revenue will be around Bt4.0-Bt4.5 billion per annum during 2019-2021.
- Operating margin will range at 35%-40%.
- Capital expenditure will total Bt1.1 billion over the next three years.

RATING OUTLOOK

The "stable" outlook reflects the expectation of TRIS Rating that SQ will maintain its competitive position as a mining contractor, serving both public sector and private sector clients. SQ will perform in accordance with the terms of the contracts and prudently manage its costs throughout the lengths of the projects. The operating margin will exceed 35% while the FFO to debt ratio is expected to stay around 15%-20%. SQ's debts should decline steadily over the course of the projects. The high debt level will be offset by the predictability of the revenue streams from the projects.

RATING SENSITIVITIES

The rating could be revised downward if the operating performance of SQ falls short of expectations. A negative rating pressure could develop if the FFO to debt ratio falls below 15% for a sustained period. A rating upside is limited in the medium term as leverage is expected to remain high. However, the rating or outlook could be revised upward if cash flow grows and the debt load drops to a great extent.

COMPANY OVERVIEW

SQ was established in May 2001 by the Sirison family and the Areekul family, 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. The company is 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. EGAT includes SQ on its short list of technically qualified contractors, reflecting SQ's strong position in mining services. Most of SQ's revenue is generated by the projects at the Mae Moh mine. The projects at the Mae Moh mine have accounted for more than 70% of its total revenue annually over the past three years.

Following robust growth in operations, 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 April 2019, this founding family held a 26% stake in the company.

SQ's revenue has grown continually over the past few years after it won contracts for the Hongsa mine and the Mae Moh Phase 8 project. The latter is currently the largest project in the backlog. Revenue in 2018 was Bt3.6 billion, up from Bt3.2 billion in 2017. Revenue in the first quarter of 2019 was Bt1.2 million, up 49% from the same period last year. The operating margin was 37%-41% during 2015-2017. The operating margin in 2018 dropped to 25.2%, but later improved to 38.9% in the first quarter of 2019.

KEY OPERATING PERFORMANCE

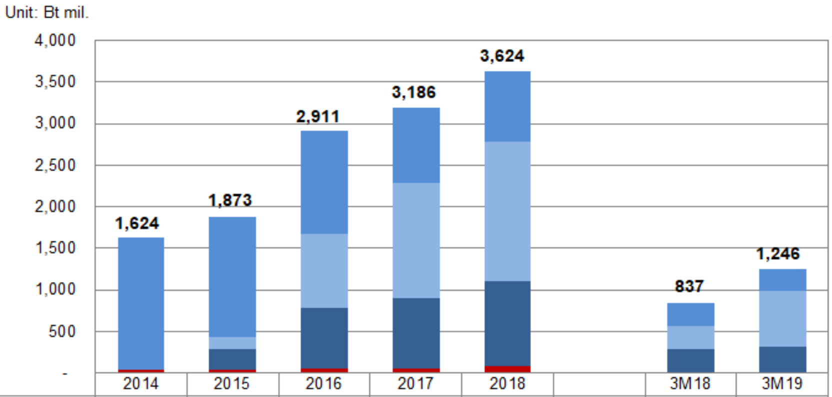
Table 1: SQ's Projects in the Backlog as of Mar 2019

Unit: Bt million

Projects	Duration	Backlog Value (Bt Million)	Total (%)
Mae Moh Phase 8	2016-2025	18,106	59
Hongsa mine	2015-2026	9,620	32
O&M Hongsa	2020-2026	2,265	7
Mae Moh Phase 7	2012-2020	487	2
Total		**30,478**	**100**

Source: SQ

Chart 1: Revenue Breakdown



	2014	2015	2016	2017	2018		3M18	3M19
Mae Moh Phase 7	1,585	1,445	1,238	905	848		267	261
Mae Moh Phase 8	-	146	897	1,376	1,673		287	673
Hongsa	-	247	731	857	1,027		273	297
Others	39	35	46	47	77		10	15

Source: SQ

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Bt million

		--------------Year Ended 31 December			-----------
	Jan-Mar 2019	2018	2017	2016	2015
Total operating revenues	1,246	3,624	3,186	2,911	1,873
Operating income	485	913	1,186	1,195	707
Earnings before interest and taxes (EBIT)	189	(123)	575	584	235
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	485	913	1,186	1,195	707
Funds from operations (FFO)	388	760	974	960	585
Adjusted interest expense	102	287	137	135	90
Capital expenditures	170	2,268	4,974	638	1,737
Total assets	11,714	11,987	10,241	6,004	4,489
Adjusted debt	7,539	7,639	4,727	1,544	2,122
Adjusted equity	2,258	2,166	2,578	2,251	740
Adjusted Ratios					
Operating income as % of total operating revenues (%)	38.91	25.18	37.22	41.04	37.74
Pretax return on permanent capital (%)	0.68 **	(1.37)	9.14	14.94	9.66
EBITDA interest coverage (times)	4.77	3.18	8.66	8.84	7.85
Debt to EBITDA (times)	6.41 **	8.37	3.99	1.29	3.00
FFO to debt (%)	12.82 **	9.95	20.60	62.20	27.54
Debt to capitalization (%)	76.95	77.91	64.71	40.68	74.16

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

RELATED CRITERIA

- Key Financial Ratios and Adjustments, 5 September 2018
- Rating Methodology – Corporate, 31 October 2007

Sahakol Equipment PLC (SQ)

Company Rating:	BBB-
Rating Outlook:	Stable

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