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KOLAO HOLDINGS

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Company Rating: BBB-

Outlook: Stable

Rating Rationale

TRIS Rating assigns the company rating of Kolao Holdings (KOLAO) at "BBB-". The rating reflects KOLAO's proven track record in the automotive industry in the Lao People's Democratic Republic (Lao PDR), solid competitive position, high operating efficiency, and acceptable financial profile. These strengths are partially offset by heightened competition, the cyclical nature of the automotive industry, and the evolving regulatory framework in the Lao PDR, of which sovereign rating is "BBB+" with "negative" outlook.

KOLAO has a long track record in the Lao automotive industry. It is the largest South Korean-owned automaker and distributor in the country. KOLAO, through its subsidiary Kolao Developing (KDC), started business as an importer of used automobiles from Korea in 1997, before expanding to the new automobile distribution in 2000 and automobile production in 2003. KOLAO was listed on the Korea Exchange (KRX) in 2010. Mr. Sei-Young OH, the founder, has been the chief executive officer (CEO) and chairman of KOLAO since inception. He is also the major shareholder, holding about 44% of the company as of March 2017. The long presence in the market creates KOLAO's strong brand awareness in the Lao PDR.

Currently, KOLAO is the sole distributor of Hyundai and Kia vehicles in the Lao PDR. The majority of products KOLAO sells under the two brands are passenger cars. The company is also the sole distributor of KR motorcycles. The motorcycles are produced by KR Motors, a Korean-listed company, in which KOLAO owned about 25% as of March 2017. In addition, KOLAO has one in-house motorcycle brand, KOLAO, and one in-house pickup truck and truck brand, DAEHAN. The company imports auto parts, mainly from Korea and China, in completely knocked down (CKD) forms, and assembles automobiles for its in-house brands at its plants in Savannakhet province.

In TRIS Rating's view, KOLAO has a very strong competitive position in the Lao PDR. The company's competitive edge is attributed to its diverse range of products and services. KOLAO offers motorcycles, passenger cars, pickup trucks, trucks, and heavy vehicles. A wide range of products enables KOLAO to capture various groups of customers. The company also provides after-sales service, auto financing, as well as buy-back and trade-in services. These products and services helped boost revenue during the past few years. Currently, KOLAO and Toyota dominate the car market in the Lao PDR. KOLAO has a solid market share in the passenger car segment, while Toyota is strong at the pickup truck segment. Taking into consideration the number of units sold in all segments of the car market, KOLAO ranked first, taking about 43% share in 2016. Toyota took up about 34%.

Competition in the Lao automotive market has become more intense. The import tariffs for vehicles built in ASEAN countries were recently cut to zero, under the terms of the ASEAN Free Trade Agreement (AFTA). The new tariffs, effective from the beginning of 2016 onwards, meant more attractive prices for Toyota imported sedans, and a corresponding drop in KOLAO's sales of Hyundai and Kia cars in 2016 and in the first quarter of 2017. To tackle the decline in sales of sedans, KOLAO opened semi knocked down (SKD) assembly lines for Hyundai and Kia cars in the first quarter of 2017. This strategic move reduces the costs of Hyundai and Kia cars, due to the tax incentives for manufacturers. Going forward,

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KOLAO will import fewer Hyundai and Kia cars, but manufacture them instead. TRIS Rating believes that the new SKD assembly lines will help KOLAO regain its competitive position in the passenger car segment. The lower cost Hyundai and Kia cars will create pricing flexibility. KOLAO can cut prices, while maintaining profits.

KOLAO's dynamic strategy will keep it competitive. The ability to adapt, in response to changes in the business environment, is the core strength of KOLAO. As an illustration, the company adapted its original business to trading local used cars within one year after the Lao government banned used-car imports in 2012. The launch of DAEHAN brand in 2013 let KOLAO not only tap the large demand for pickup trucks and trucks, but also enjoy tax incentives. As a result, revenue and earnings held steady, despite the evolving business environment. TRIS Rating expects KOLAO's revenue in 2017 will be under pressure from intense competition, mostly from imported cars. Revenue will get back on track in 2018, when KOLAO boosts production of the SKD Hyundai and Kia cars. Moreover, KOLAO aims to penetrate its existing markets such as Cambodia, Myanmar, Vietnam, and Pakistan. Revenue from such markets made up less than 10% of total revenue during the past three years. The successes in market penetration will be a plus for the company's rating, particularly in terms of diversification. In contrast, a significant loss in market share in the Lao automotive market or the lack of success in market penetration will adversely affect the rating of KOLAO.

KOLAO's profitability recently declined, but remained strong. The new prices of Toyota sedans forced KOLAO to lower the prices of its comparable models. As a result, the operating margin (operating income before depreciation and amortization as a percentage of sales) slid to 11.2% in the first quarter of 2017, from 14.9% in 2016. The operating margin should improve once the production of the SKD Hyundai and Kia cars ramps up. However, the operating margin may not be as high as in the past due to heightened competition. In addition, KOLAO stopped providing its in-house auto financing program in 2017. Financial services are currently provided by its banking affiliate, Indochina Bank, and other banking alliances. As a result, interest income from installment sales will decline gradually. KOLAO's operating margin is expected to stay around 10% over the next three years. KOLAO may resume its in-house auto financing program once its liquidity position improves.

TRIS Rating expects the capital structure of KOLAO will improve after the discontinuation of its in-house auto financing. However, leverage will not decline rapidly because KOLAO needs funds to expand. The total debt to capitalization ratio is projected to stay below 30% over the next three years. Cash flow protection will rise as leverage falls. The ratio of funds from operations (FFO) to total debt will exceed 25%, from the current level of below 20%.

Liquidity is tight, but still manageable. As of March 2017, KOLAO had cash and marketable securities of US$17 million and unused credit facilities of US$34 million. FFO was US$20-US$30 million per annum. Sources of funds, thus, totaled about US$80 million. The debts coming due in the next 12 months are US$124 million in total. These include a SG$60 million bond, guaranteed by Credit Guarantee and Investment Facility (CGIF), due in August 2017. The shortfall of US$44 million will be funded by the proceeds from the collection of trade receivables, worth US$94 million. Most of KOLAO's debts are working capital loans.

Rating Outlook

The "stable" outlook reflects the expectation that KOLAO will maintain its competitive position in the Lao automotive market, while keeping its financial profile at the current level.

The rating and/or outlook could be revised upward if KOLAO can improve its market position, while its financial profile stays firm.

The rating and/or outlook could be lowered if KOLAO loses a significant amount of market share in the Lao automotive market, or if its profitability or financial profile deteriorates significantly.

Kolao Holdings (KOLAO)

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Rating Outlook:	Stable

Financial Statistics and Key Financial Ratios *

Unit: US$ million

	Jan-Mar 2017	----------- Year Ended 31 December ------ 2016	2015	2014	2013
Revenue	77	338	393	361	305
Gross interest expense	6	10	5	5	4
Net income from operations	8	36	41	40	25
Funds from operations (FFO)	4	21	34	22	31
Capital expenditures	1	9	13	25	24
Total assets	583	571	512	416	325
Total debts	157	142	136	101	52
Shareholders' equity	369	362	329	290	258
Operating income before depreciation and amortization as % of sales ***	11.2	14.9	12.1	10.9	11.5
Pretax return on permanent capital (%)	10.1**	9.8	9.3	10.8	14.9
Earnings before interest, tax, depreciation, and amortization (EBITDA) interest coverage (times)	2.8	5.7	7.9	7.2	7.5
FFO/Total debt (%)	17.0 **	18.0	27.9	24.5	61.6
Total debt/capitalization (%)	29.8	28.1	29.3	25.9	16.9
Total debt/capitalization (%) ****	29.0	26.6	27.1	24.0	14.0

Note: All ratios are operating lease adjusted
** Consolidated financial statements*
*** Annualized with trailing 12 months*
**** Including net interest income from installment sales*
***** Excluding capitalized annual leases*

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