TRIS RATING

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LVMC HOLDINGS

No. 100/2020

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CORPORATES

Company Rating:	BB
Outlook:	Negative

Last Review Date: 22/07/19

Company Rating History:

Date	Rating	Outlook/Alert
22/07/19	BB+	Negative
26/07/18	BB+	Stable
06/07/17	BBB-	Stable

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RATIONALE

TRIS Rating downgrades the company rating on LVMC Holdings (LVMC), previously known as Kolao Holdings (KOLAO), to "BB" from "BB+". The rating action mirrors a slower-than-expected recovery in operating performance. At the same time, we maintain the rating outlook on LVMC at "negative" to reflect the highly competitive and uncertain business environments, as well as, the likelihood that the company's operating performance will continue to fall below expectations. The change in rating outlook also follows a financial covenant breach in the guaranteed debentures of USD25.7 million issued by the company's subsidiary, LVMC Holdings Singapore Pte. Ltd. (LVMCS). The debentures are jointly and severally guaranteed by LVMC and Kolao Developing Co., Ltd. (KDC).

The "BB" rating mirrors LVMC's deteriorating competitiveness in the Lao People's Democratic Republic's (Lao PDR) automotive market and the heightened operational risks associated with overseas expansions. The rating also takes into consideration fluctuations in exchange rates and the cyclical nature of the automotive industry.

KEY RATING CONSIDERATIONS

Weaker-than-expected recovery

LVMC has put much effort into restoring its operating performance after losing competitiveness in its main market. The company has expanded into other markets to offset a decline in revenue and earnings in the Lao automotive market. It has also focused more on profitable car models and implemented cost cutting to regain profitability.

TRIS Rating previously expected the harvesting periods after the company's overseas expansion to start from 2019. Despite a recent improvement, the company's EBITDA (earnings before interest, tax, depreciation, and amortization) and EBITDA margin (EBITDA as a percentage of total operating revenues) remained below our expectations.

We believe LVMC's operating performance will improve gradually over the next three years, but is unlikely to reach the levels we previously forecast. The highly competitive and uncertain environments in the countries where the company operates could impede improvements. The performance recovery should also take a longer time as the coronavirus (COVID-19) pandemic is lowering car demand. Additional revenue from other markets will help lessen an adverse impact on revenue and create growth over the medium to long term. Our base case forecast assumes total operating revenue will decline slightly in 2020, before rising to nearly USD420 million in 2022. EBITDA should gradually reach USD36 million in the next three years, with an EBITDA margin of about 5%. In the past, EBITDA ranged between USD40-USD60 million per annum, while the EBITDA margin stayed above 10%.

Declining competitiveness in core market

LVMC's market position in the Lao automotive market is not as strong as before, in TRIS Rating's view. Revenue from the Lao PDR made up the majority (nearly 70%) of total revenue in 2019. The company's products are losing popularity, due not only to a loss in price advantage but also a rapid change in customer preferences. LVMC's sales performance in its main market has declined steadily after import tariffs for vehicles built in the Association of

Southeast Asian Nations (ASEAN) countries were cut to zero in 2015.

The zero import tariffs have changed the competitive landscape in the Lao automotive market, favoring car makers with production bases in ASEAN, including Toyota, LVMC's major competitor. Prices of imported completely built-up (CBU) Japanese sedans have dropped significantly. LVMC, in 2017, opened its assembly lines for semi knocked down (SKD) "Hyundai" and "Kia" cars in the Lao PDR. Assembling, instead of importing from South Korea, helps lower the costs by almost 30% due to the tax incentives for manufacturing. Despite a price cut, LVMC's sales in the Lao PDR continued to fall.

Customer behavior in the Lao PDR has also changed. The Lao people have become more comfortable with purchasing on credit, as several banks have penetrated the hire purchase business. The Lao people are willing to pay higher prices for the latest car models. Japanese automakers, like Toyota, seem to be benefiting. LVMC has adapted its marketing strategy to address the change by launching new car models. Competition has become more intense as Toyota is penetrating the market.

Overseas expansion brings risks and growth

The recent expansion into other markets such as Vietnam, Myanmar, Cambodia, and Pakistan, has raised LVMC's operational risks. The emerging countries expose the company to regulatory risk. Evolving regulatory frameworks cause operational uncertainty, which could benefit or damage players in the industry. The imposition of new import tariffs in the Lao PDR is an example of changes in regulations which negatively impact existing players like LVMC.

Furthermore, LVMC has to contend with several existing large manufacturers in other countries. In Vietnam, for example, the company has to compete with Truong Hai Auto Corporation (THACO), a large local car maker which holds the largest share of about one quarter of the automobile market. LVMC's operating performance in this market has remained sluggish due to the intense competition. In February 2020, LVMC sold a 15% stake in its operating company in Vietnam, Daehan Motors. As a result, Daehan Motors becomes an associated company of LVMC.

LVMC has also become more exposed to fluctuations in exchange rates. An overseas expansion raises the exchange rate risk as LVMC's automobiles are priced in local currencies. However, LVMC imports automobiles and auto parts in US dollars. Currency movements could weaken operating performance if the company does not manage the currency mismatch properly.

On the plus side, additional revenue from new markets should help LVMC's operating performance recovery. TRIS Rating expects Myanmar and Cambodia to bring growth to LVMC. In Myanmar, its assembly lines for SKD Hyundai cars started production in the first quarter of 2019. The launch of SKD Hyundai has enabled the company to sell automobiles to the people of Yangon. Only locally assembled vehicles can be registered in Yangon. In Cambodia, LVMC has recognized revenue from selling imported new and used cars since mid-2019. However, successful expansions into new markets will take time to realize.

Tight, but manageable liquidity

Liquidity is tight as LVMC has a large amount of debt coming due this year. During the remaining eight months of 2020, debts of USD119 million will come due. At the end of April 2020, the company had cash and marketable securities, plus undrawn credit facilities, of about USD50 million. Funds from operations (FFO) during the remaining eight months of 2020 are expected to reach about USD3 million. The company will also receive USD11 million in loan repayments from its associate company. As a result, sources of cash are estimated at USD64 million. Short-term installment sales receivables, worth almost USD90 million, can be used as another source of cash to support the short fall of about USD55 million.

LVMC is in the process of raising new capital of about USD80 million to support its liquidity and expansion including a new SKD Hyundai plant in Myanmar. Total capital expenditure over the next three years is estimated to be below USD30 million. Proceeds from the capital increase after the capital spending will lessen concerns over the company's liquidity and level of leverage. With our base-case assumption of a new capital injection of about USD40 million, the debt to EBITDA ratio should fall to 4.5-7.5 times during 2020-2022, down from 8.5 times in the first quarter of 2020. The FFO to debt ratio should improve gradually, reaching 13% in the next three years.

The company has breached a financial covenant in the guaranteed debentures of USD25.7 million issued by LVMCS. The debentures are jointly and severally guaranteed by LVMC and KDC. The debentures require LVMC to keep the total liabilities to equity ratio at or below 1 time. The ratio was 1.08 times as of December 2019 and 1.13 times as of March 2020. The company has sent a notice letter to inform the bondholders' representative, regarding the covenant breach.

BASE-CASE ASSUMPTIONS

- Total operating revenue to slide in 2020, before rising to nearly USD420 million in 2022.
- EBITDA margin to recover gradually to about 5% in the next three years.
- Total capital spending to range around USD5-USD15 million per annum.

RATING OUTLOOK

The "negative" outlook reflects our expectation that the highly competitive and uncertain business environments in which LVMC operates will continue and the recovery prospects are uncertain. In addition, the company was unable to comply with the financial covenant in the guaranteed debentures of USD25.7 million issued by LVMCS.

RATING SENSITIVITIES

A rating upside is limited in the near term. It could arise if the overseas expansion is successful as LVMC plans, helping restore the operating performance, and if the debt to EBITDA ratio falls below 5 times on a sustained basis. In contrast, rating pressure will occur if the improvement in operating performance is significantly weaker than our expectations.

COMPANY OVERVIEW

LVMC, formerly known as KOLAO, is the largest South Korean-owned automaker and distributor in the Lao PDR. Mr. Sei-Young Oh, the founder, has been the chief executive officer (CEO) and chairman of the company since its inception. He is also the major shareholder, holding about 45% of the company as of April 2020.

LVMC has a long presence in the Lao automotive industry. The company imported used automobiles from South Korea in 1997 and later gave up the business. LVMC entered into distribution agreements with Kia in 2000 and Hyundai in 2001 to sell new automobiles. LVMC then expanded its scope of business from trading to manufacturing. The company launched its own motorcycle brand, "KOLAO", in 2003 and its own pickup truck and truck brand, "DAEHAN", in 2013. LVMC imports auto parts in completely knocked down (CKD) form. It then assembles the automobiles and sells the vehicles under its own brand names. In early 2017, the company opened SKD assembly lines for Hyundai and Kia vehicles. LVMC is expanding into other markets including Vietnam, Myanmar, Pakistan, and Cambodia.

LVMC currently has six lines of business: new cars sold under distributorship agreements, new CKD and SKD cars, trading used cars, new motorcycles, auto parts, and after-sales services. In 2019, sales of new CKD and SKD cars made up the greatest share (46%) of total revenue, followed by sales of used cars (44%). Other sources of revenue comprised sales of new cars under dealership agreements (7%), auto parts and after-sales services (3%), and new motorcycles (0%).

KEY OPERATING PERFORMANCE

Table 1: Revenue Breakdown

Unit: %

	2015	2016	2017	2018	2019
New cars under dealership agreements	56	41	38	12	7
New CKD & SKD cars	28	41	33	40	46
Used cars	6	10	23	43	44
New motorcycles	4	3	2	1	0
Auto parts and after-sales services	2	2	4	4	3
Others	3	3	0	1	0
Total	**100**	**100**	**100**	**100**	**100**
Total revenue (Mil. USD)	**393**	**338**	**295**	**267**	**312**

Source: LVMC

Table 2: Gross Profit Margin by Segment

Unit: %

	2015	2016	2017	2018	2019
New cars under dealership agreements	23	17	11	12	16
New CKD & SKD cars	21	26	27	3	10
Used cars	13	7	0	(4)	1
New motorcycles	10	6	(8)	(43)	(226)
Auto parts and after-sales services	7	27	26	7	36
Others	6	15	100	50	5
Total	**20**	**20**	**15**	**2**	**7**

Source: LVMC

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS

Unit: Mil. USD

		------------- Year Ended 31 December ------------			
	Jan-Mar 2020	2019	2018	2017	2016
Total operating revenues	97	339	318	353	373
Earnings before interest and taxes (EBIT)	5	(14)	(23)	23	47
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	10	22	11	43	61
Funds from operations (FFO)	3	(3)	(5)	31	50
Adjusted interest expense	7	22	16	11	11
Capital expenditures	27	25	14	14	14
Total assets	585	586	585	589	571
Adjusted debt	212	225	196	146	128
Adjusted equity	275	282	322	371	362
Adjusted Ratios					
EBITDA Margin (%) *	4.39	1.31	(0.96)	9.19	13.69
Pretax return on permanent capital (%)	(1.90) **	(2.68)	(4.25)	4.38	9.72
EBITDA interest coverage (times)	1.38	0.99	0.69	3.83	5.70
Debt to EBITDA (times)	8.46 **	10.32	17.32	3.42	2.11
FFO to debt (%)	(0.98) **	(1.34)	(2.76)	21.36	38.93
Debt to capitalization (%)	43.59	44.41	37.87	28.23	26.11

Note: Consolidated financial statements
** Including net interest income from installment sales*
*** Adjusted with trailing 12 months*

RELATED CRITERIA

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

LVMC Holdings (LVMC)

Company Rating:	BB
Rating Outlook:	Negative

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