TRIS RATING
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LVMC HOLDINGS

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CORPORATES

Company Rating:	BB+
Outlook:	Stable

Company Rating History:

Date	Rating	Outlook/Alert
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 "BBB-". The rating downgrade reflects a larger-than-expected drop in LVMC's operating performance. Competition in the automotive industry of the Lao People's Democratic Republic (Lao PDR) became more intense than expected. The severe competition forced LVMC to cut prices and spend more on sales promotions to preserve its market share. The additional costs related to an overseas expansion also pressured profits. Income contribution from overseas markets will increase its importance from 2019 onwards.

The rating also reflects LVMC's exposure to evolving regulatory frameworks in several developing countries, fluctuations in exchange rates, and the cyclical nature of the automotive industry. However, LVMC's leading position in the Lao automotive market and fairly low financial leverage help support its rating.

TRIS Rating forecasts a slump in LVMC's earnings in 2018. Therefore, the company has a high possibility to breach a financial covenant on its debentures. The debentures require LVMC to maintain the interest-bearing debt to EBITDA (earnings before interest, tax, depreciation and amortization) ratio at or below 5 times at the end of each year. TRIS Rating expects LVMC to get waivers from bondholders in advance. Based on our projection, LVMC's operating performance should recover gradually such that the interest-bearing debt to EBITDA ratio drops to below 5 times by the end of 2019.

KEY RATING CONSIDERATIONS

Profits squeezed by heightened competition in the key market

LVMC's profitability dropped significantly in the first quarter of 2018. The gross margin of the auto sales segment declined to 5.0% from 14.8% in 2017 and 19.9% in 2016. Intense competition in the Lao automotive market forced LVMC to lower prices of its automobiles to preserve market share. A large drop in new car sales volume made the company lose economies of scale. In addition to a drop in gross margin, selling and administrative expenses rose remarkably. LVMC offered more sales promotions to beat competitors. The company also incurred additional operating expenses related to its overseas expansion.

TRIS Rating expects competition in the Lao automotive market will remain intense and continue to squeeze industry profit margins. The cut on import tariffs to zero for vehicles built in the Association of Southeast Asian Nations (ASEAN) countries at the end of 2015 has changed the competitive landscape. Importers of car brands produced in the ASEAN countries benefit from the lower import costs. Such importers have aggressively offered sales promotions as a consequence.

LVMC, as an importer of the Hyundai and Kia cars, is losing price competitiveness because these car brands are manufactured in South Korea, not an ASEAN member country. The company's in-house DAEHAN pickup trucks and trucks have also been challenged by both existing players and newcomers.

Competitiveness to recover, but not as strong as before

TRIS Rating believes LVMC will be able to restore its competitiveness in the Lao automotive market. However, the restoration should take at least 2-3 years. The company opened assembly lines for semi knocked down (SKD) Hyundai and

Kia cars in 2017. Assembling, instead of importing, helps lower costs as LVMC enjoys tax incentives for manufacturing. The results should become clearer in 2019 when we expect the SKD production to reach economies of scale.

However, LVMC's competitiveness in the Lao automotive market will not be as strong as before, in our opinion. Selling prices for Japanese sedans fell significantly. Before the new import tariffs, the average price for Toyota sedans was about US$30,000, while Hyundai and Kia sedans averaged about US$24,000. Currently, the average price for Toyota sedans is about US$26,000, while Hyundai and Kia sedans remain about the same. The SKD production will lower costs and hence widen the average price gap between Toyota sedans and Hyundai and Kia sedans. Nevertheless, the average price gap may not be as wide as before.

TRIS Rating expects LVMC to record low revenue of about US$280 million in 2018 and return to grow in 2019. Our forecast assumes revenue will increase to US$334 million in 2020. The recovery in revenue reflects our expectations that the SKD production for the Hyundai and Kia cars will help regain LVMC's price competitiveness in the Lao automotive market. In addition, revenue from overseas markets, including Vietnam, Pakistan, and Myanmar, will start to make a significant contribution to LVMC's total revenue in 2019.

Similarly, profitability will improve, but remain below the past levels. We project the operating margin (operating income before depreciation and amortization as a percentage of sales) will reach a bottom of 1.4% in 2018 and rise steadily to nearly 5.0% during 2019-2020. Past records showed the operating margin staying above 10.0%. In the first quarter of 2018, the operating margin fell sharply to 1.2%.

Exposure to evolving regulatory framework

LVMC will continue to face evolving regulatory frameworks because it currently operates in emerging markets such as the Lao PDR, Vietnam, and Myanmar. Evolving regulatory frameworks cause operational uncertainty, which could benefit or damage market players. The new import tariffs in the Lao PDR illustrate a severe impact to existing players like LVMC. The company's expansion into other developing countries like Vietnam and Myanmar can be both an opportunity and a threat. LVMC enjoys tax incentives for manufacture as it set up a new production plant in Vietnam. Furthermore, Vietnam announced new emissions and safety standards at the beginning of 2018. All imported cars are required to have Vehicle Type Approval (VTA). The VTA makes it more difficult for automobile importers, but benefits local manufacturers like LVMC. However, as a newcomer, LVMC has to compete with several large manufacturers in Vietnam.

Increasing exposure to fluctuations in exchange rates

Exposure to fluctuations in exchange rates will increase. The Lao government introduced a number of measures to promote the use of Kip. For example, since 2017, automobiles sold in the Lao PDR have been priced in Kip, not in US dollars as in the past. 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. Moreover, the company's overseas expansion raises the exchange rate risk as LVMC's automobiles are priced in local currencies.

Financial leverage to decline

TRIS Rating expects a gradual decrease in leverage because the company has downsized its in-house auto financing segment since 2017. However, leverage will not drop sharply as we expect LVMC will continue to provide auto loans. Installment sales should make up 5.0%-15.0% of revenue from car sales, based on our projection. The net interest received from installment sales will help maintain overall profit when the profit margin of the auto sales segment drops. In addition, LVMC may need more working capital to finance a rise in inventory after it has penetrated the used car segment and expanded to other countries. The total debt to capitalization ratio will stay at 20.0%-30.0% during 2018-2020. The company has no major capital expenditure plans during the next three years. At the end of March 2018, the total debt to capitalization ratio stood at 32.1%. Due to a limited access to capital markets in the countries LVMC operates, LVMC should keep leverage low.

Our forecast assumes LVMC's cash flow in relation to debts will improve as the operating performance recovers and debt falls. However, the FFO (funds from operations) to total debt ratio is unlikely to restore to the past levels of above 25.0%. The ratio was 18.0% as of March 2018 (annualized with trailing 12 months data) and we expect it will drop to below 10.0% by the end of 2018. The FFO to total debt ratio will recover, ranging between 10.0%-15.0% during 2019-2020.

High possibility of a financial covenant violation this year

LVMC is unlikely to stay in compliance with the financial covenant on its debentures at the end of 2018, as we project a slump in earnings this year. A key financial covenant in LVMC's debentures requires the company to maintain the interest-bearing debt to EBITDA ratio at or below 5 times at the end of each year. We expect LVMC to get waivers from bondholders prior to the end of this year. Next year, we expect the operating performance will improve such that the interest-bearing debt to EBITDA ratio falls to below 5 times.

Liquidity should be manageable due to the fairly low debt level. Most of the debts (80.0%) are short-term to fund installment sales receivables and inventories. In case of a liquidity shortage, installment sales receivables can be used as another source of cash. The installment sales receivables after debts were worth nearly US$40 million as of March 2018. The debentures worth US$25.7 million will come due in 2020 when we expect the operating performance to have already improved.

RATING OUTLOOK

The “stable” outlook reflects our expectation that LVMC will be able to regain its competitiveness in the Lao automotive market and restore profitability gradually. Revenue from other countries should help boost operating performance.

RATING SENSITIVITIES

A rating upgrade could materialize if LVMC’s overseas expansion is successful as planned, while the operating margin improves to above 5.0% and the FFO to total debt ratio improves to more than 20.0% on a sustained basis. In contrast, the rating and/or outlook could be downgraded if revenue and profits continue to decline or if LVMC could not comply with financial covenants in its debentures after 2018.

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 inception. He is also the major shareholder, holding about 44.0% of the company as of March 2018. At the beginning of 2018, LVMC appointed Mr. Hyung-seung Lee as a co-CEO to support the company’s overseas expansion.

LVMC has a long presence in the Lao automotive industry. The company, through its subsidiary Kolao Developing (KDC), started business as an importer of used automobiles from South Korea in 1997. It 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, mainly from South Korea and China, in completely knocked down (CKD) form. It then assembles the automobiles at its two plants in Savannakhet province and sells the vehicles under its own brand names. In the first quarter of 2017, LVMC opened SKD assembly lines for the Hyundai and Kia vehicles.

LVMC and Toyota are the two largest players in the Lao automotive market. LVMC continued to rank first, with a market share of about 43.0% in 2017, taking into consideration the number of units sold in all segments of the car market. However, Toyota’s market share rose significantly to about 37.0% in 2017, from nearly 24.0% in 2015.

LVMC has expanded recently to other countries. In 2017, LVMC set up Daehan-Dewan Motor, a subsidiary, to produce and sell CKD pick-up trucks and trucks under the “Daehan Shehzore” brand in Pakistan. LVMC held a 50.0% stake in the subsidiary and Yousaf Dewan Companies held the rest. Moreover, LVMC acquired a 60.0% stake in Daehan Motors, a producer and seller of trucks under the “Teraco” brand in Vietnam. LVMC paid US$7.5 million for the stake in January 2018. Ownership was transferred to LVMC in April 2018. Daehan Motors was setup in 2015. It recorded sales of about US$12 million in 2017, the first operating year. LVMC is also constructing a SKD plant for its automobiles in Myanmar. LVMC expects to finish the plant construction in the last quarter of 2018.

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 the first quarter of 2018, sales of used cars made up the majority (47.0%) of total revenue, followed by sales of new cars under dealership agreements (28.0%). Other sources of revenue were the sales of new CKD and SKD cars (19.0%), auto parts and after-sales services (5.0%), and new motorcycles (1.0%). Sales of used cars rose recently, as LVMC attempted to penetrate this market segment.

KEY OPERATING PERFORMANCE

Table 1: Revenue Breakdown

Unit: %

	2014	2015	2016	2017	Jan-Mar 2018
New cars under dealership agreements	66	56	41	38	28
New CKD & SKD cars	19	28	41	33	19
Used cars	4	6	10	23	47
New motorcycles	5	4	3	2	1
Auto parts and after-sales services	2	2	2	4	5
Others	4	3	3	0	1
Total	**100**	**100**	**100**	**100**	**100**
Total revenue (US$ million)	**361**	**393**	**338**	**295**	**68**

Source: LVMC

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: US$ million

		---------- Year Ended 31 December ----------			
	Jan-Mar 2018	2017	2016	2015	2014
Revenue	68	295	338	393	361
Gross interest expense	5	10	10	5	5
Net income from operations	(4)	12	36	41	40
Funds from operations (FFO)	10	34	54	49	24
Capital expenditures	1	16	14	13	25
Total assets	615	589	571	512	416
Total debts	174	175	142	136	101
Shareholders' equity	369	371	362	329	290
Operating income before depreciation and amortization as % of sales ***	1.2	11.2	13.6	12.1	10.9
Pretax return on permanent capital (%)	3.0 **	5.7	9.4	9.8	10.6
Earnings before interest, tax, depreciation, and amortization (EBITDA) interest coverage (times)	0.9	3.9	5.5	8.3	7.1
FFO/total debt (%)	18.0 **	21.6	41.4	38.4	26.6
Total debt/capitalization (%)	32.1	32.0	28.1	29.3	25.9
Total debt/capitalization (%) ****	31.1	30.2	26.6	27.1	24.0

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

LVMC Holdings (LVMC)

Company Rating:	BB+
Rating Outlook:	Stable

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