TRIS RATING
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LVMC HOLDINGS

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CORPORATES

Company Rating:	BB+
Outlook:	Negative

Last Review Date: 26/07/18

Company Rating History:

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

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RATIONALE

TRIS Rating affirms the company rating on LVMC Holdings (LVMC), previously known as Kolao Holdings (KOLAO), at “BB+”. At the same time, we revise the rating outlook on LVMC to “negative” from “stable”. The “negative” outlook reflects a significant drop in LVMC’s operating performance in the Lao People’s Democratic Republic (Lao PDR), the company’s core market. The company might take a longer time than previously expected to restore its operating performance.

The rating reflects LVMC’s deteriorating market position in the Lao PDR’s automotive market, the heightened operational risks associated with expansions into Vietnam and Myanmar, as well as its weakening financial profile. Deterioration in its profitability and capital structure is challenging LVMC to comply with a financial covenant in its debentures. The rating also takes into consideration fluctuations in exchange rates and the cyclical nature of the automotive industry.

KEY RATING CONSIDERATIONS

Deterioration in competitiveness

TRIS Rating expects LVMC’s competitive edge in the Lao automotive market will recover, but at a slower pace than previously expected. The company’s market position will also not be as strong as before. Its 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 has declined remarkably 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, 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 continued to fall until the first quarter of 2019.

Customer behavior in the Lao PDR has 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. It has sold off its old car models at low prices and launched newer car models. The success of this marketing strategy remains to be seen.

Weakening financial profile

TRIS Rating expects the debt level of LVMC in relation to earnings will remain high. The ratio of debt to EBITDA (earnings before interest, taxes, depreciation, and amortization) will stay at about 7 times in 2019, before declining gradually to below 5 times within 2021, given our base case scenario. The ratio of funds from operations (FFO) to debt is unlikely to restore to past levels of above 25%. Our forecast assumes the ratio will reach 17% in the next three years.

We also expect profitability will not recover to past levels. The gross margin plummeted to single digits during 2018 throughout the first quarter of 2019. The operating margin (operating income as a percentage of total operating revenues) turned negative in 2018, before recovering to a thin level of 2.3% in the first quarter of 2019. The plunge in profits was because the company cleared up its old model cars at low prices. In addition, it incurred pre-operating expenses associated with new market expansion. LVMC is now focusing more on profitable car models. It has attempted to cut costs by downsizing the Laos operations. Additional revenue from markets other than the Lao PDR will also help reduce selling, general, and administrative (SG&A) expense as a percentage of revenue. Our base case forecast assumes the gross margin will improve gradually to about 14% and the operating margin will improve to about 7% within 2021. In the past, the former ratio stayed above 20% and the latter ratio stayed above 10%. Total operating revenue should again begin to grow, reaching US$365 million in the next three years.

Heightened operational risks due to overseas expansion

Despite additional revenue, expansion into other emerging markets will raise operational risks. LVMC is expanding into other developing countries such as Vietnam, Myanmar, Pakistan, and Cambodia. These 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 fight 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 occupying the largest share of about one quarter of this automobile market.

LVMC will also have more exposure 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 will help recover LVMC's operating performance. The company will begin to harvest what it has invested during the past two years. In Myanmar, its assembly lines for SKD Hyundai cars started production in the first quarter of 2019. In Vietnam, it is expanding into the mini truck segment and the heavy duty truck segment. In Cambodia, LVMC will begin to recognize revenue from selling imported new and used cars, starting from mid-2019. However, successful overseas expansions into these new markets will take time to be evident.

Tight liquidity

Liquidity is tight. The company needs to manage cash flows carefully. During the remaining nine months of 2019, debts of about US$104 million will come due. At the end of March 2019, the company had cash and marketable securities of US$14 million. The undrawn credit facilities were US$21 million. We expect FFO during the remaining nine months of 2019 at US$10 million. Sources of cash will total US$45 million, as a result. Installment sales receivables, worth nearly US$183 million, can be used as another source of cash to support the short fall of about US$59 million. The debentures coming due this year were already rolled over. However, the refinancing risk remains our concern as debentures totaling US$34 million will come due in 2020. LVMC expects to refinance the debentures with new ones.

LVMC has a limited headroom on its financial covenant in debentures. The company has to keep the total liabilities to equity ratio at or below 1 times at all times. As of March 2019, this ratio was 0.9 times. Under TRIS Rating's base case forecast, the total liabilities to equity ratio will improve gradually. If its capital structure deteriorates further, we expect the company will get a waiver from its debenture holders in advance. The covenant to keep the interest-bearing debt to EBITDA ratio at or below 5 times was already removed.

BASE-CASE ASSUMPTIONS

- Total operating revenue will grow by about 5% a year, reaching US$365 million in the next three years.
- Operating margin will rise steadily to about 7%.
- Total capital spending will stay below US$10 million per annum.

RATING OUTLOOK

The "negative" outlook reflects a significant drop in LVMC's operating performance in the Lao automotive market. Profitability is likely to restore slower than our previous expectations. In addition, LVMC has the potential to breach the financial covenant on its debentures. Expansion into other countries with evolving regulatory frameworks will heighten operational risks. Success of its overseas expansion remains to be seen.

RATING SENSITIVITIES

The rating and/or outlook could be revised upward if LVMC's overseas expansion is as successful as the company plans. The debt to EBITDA ratio falls to below 5 times on a sustained basis. In contrast, a slower-than-expected recovery in revenue and profits may lead to a rating downgrade.

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 44% of the company as of March 2019.

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 the 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 the first quarter of 2019, sales of new CKD and SKD cars made up the majority (43%) of total revenue, followed by sales of used cars (41%). Other sources of revenue were the sales of new cars under dealership agreements (11%), auto parts and after-sales services (4%), and new motorcycles (1%).

KEY OPERATING PERFORMANCE

Table 1: Revenue Breakdown

Unit: %

	2014	2015	2016	2017	2018
New cars under dealership agreements	66	56	41	38	12
New CKD & SKD cars	19	28	41	33	40
Used cars	4	6	10	23	43
New motorcycles	5	4	3	2	1
Auto parts and after-sales services	2	2	2	4	4
Others	4	3	3	0	1
Total	**100**	**100**	**100**	**100**	**100**
Total revenue (US$ million)	**361**	**393**	**338**	**295**	**267**

Source: LVMC

Table 2: Gross Profit Margin Breakdown

Unit: %

	2014	2015	2016	2017	2018
New cars under dealership agreements	22	23	17	11	12
New CKD & SKD cars	22	21	26	27	3
Used cars	13	13	7	0	-4
New motorcycles	18	10	6	-8	-43
Auto parts and after-sales services	18	7	27	26	7
Others	10	6	15	100	50
Total	**21**	**20**	**20**	**15**	**2**

Source: LVMC

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: US$ million

		-------------- Year Ended 31 December -----------			
	Jan-Mar 2019	2018	2017	2016	2015
Total operating revenues	71	318	353	373	408
Operating income	5	6	48	59	53
Earnings before interest and taxes (EBIT)	1	(23)	23	47	44
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	6	11	43	61	56
Funds from operations (FFO)	2	(5)	31	50	48
Adjusted interest expense	5	16	11	11	6
Capital expenditures	2	14	14	14	13
Total assets	597	585	589	571	512
Adjusted debt	200	196	146	128	117
Adjusted equity	315	322	371	362	329
Adjusted Ratios					
Operating income as % of total operating revenues (%) ***	2.27	(2.50)	10.77	13.15	11.69
Pretax return on permanent capital (%)	(5.25) **	(4.25)	4.38	9.72	10.34
EBITDA interest coverage (times)	1.39	0.69	3.83	5.70	8.74
Debt to EBITDA (times)	25.85 **	17.32	3.42	2.11	2.10
FFO to debt (%)	(4.37) **	(2.76)	21.36	38.93	41.11
Debt to capitalization (%)	38.91	37.87	28.23	26.11	26.17

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

RELATED CRITERIA

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

LVMC Holdings (LVMC)

Company Rating:	BB+
Rating Outlook:	Negative

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