SAHAKOL EQUIPMENT PLC

No. 91/2021
11 June 2021

CORPORATES

Company Rating: BBB-
Outlook: Stable

Last Review Date: 22/06/20

Company Rating History:

Date	Rating	Outlook/Alert
22/06/20	BBB-	Negative
08/06/18	BBB-	Stable

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RATIONALE

TRIS Rating affirms the company rating on Sahakol Equipment PLC (SQ) at "BBB-". At the same time, TRIS Rating revises the outlook to "stable" from "negative". The outlook revision reflects a significant improvement in SQ's operating performance and our expectation that SQ will continue to deliver an acceptable level of cash flow over the course of the undertaken projects.

The rating mirrors SQ's competitive strengths in mining services and the predictable income streams from long-term service contracts with creditworthy clients. However, the rating is held back by its narrow scope of business and dependency on a few large projects.

KEY RATING CONSIDERATIONS

Long-established track record and strengths in mining services

SQ provides extensive mining services. The company has long-established track records in mining operations as it has served as the main contractor or a joint operator in several phases of the Mae Moh mining operations over the past three decades.

SQ's competitive strengths are built from its wealth of experienced mining engineers and its fleet of specialized mining equipment. SQ has secured long-term mining service contracts with the Electricity Generating Authority of Thailand (EGAT), which require mining expertise and hefty capital investment. Given the high barrier to entry, this market is dominated by a few contractors. EGAT's inclusion of SQ on its short list of technically qualified contractors reflects SQ's strong position in mining services.

SQ has looked for growth in neighboring countries, in particular the Republic of the Union of Myanmar and the Lao People's Democratic Republic (Lao PDR). The company currently holds a lignite mining service agreement with Hongsa Power Co., Ltd. (HPC), a leading power producer in the Lao PDR. The project is viewed as the start of SQ's overseas expansion.

Predictable income streams from long-term contracts

SQ's predictable income streams are underpinned by its long-term service contracts and the minimal credit risk of the mining project sponsors, EGAT and HPC. SQ has a fairly sizeable backlog, which helps secure its revenue in the medium term. As of March 2021, SQ's backlog stood at THB21.8 billion. The projects in backlog comprise the soil and coal excavation project of Mae Moh Phase 8 (THB12.2 billion), Hongsa mine (THB7.7 billion), and operation and maintenance (O&M) services for a waste line system and an ash conveyor system for HPC (THB1.9 billion). These projects in the backlog are scheduled for completion in 2025-2026.

Adding to its current backlog, SQ recently secured new contracts with HPC for its North pit wall expansion. The project is worth approximately THB830 million. It helps secure SQ's revenue for five years, starting from 2022.

Recovery in operating performance

SQ has recovered from the landslide incident at the site of Mae Moh phase 8 in 2018. The landslide which damaged key mining equipment and the slower-than-expected recovery had ravaged SQ's profitability in 2018 and 2019. However, SQ's operating performance in 2020 through the first quarter of 2021 beat our expectation. SQ reported gross margin of 21.7% in 2020 and

31.4% in the first quarter of 2021, which exceeded our expectation of 16%-22%, recovering from only 5% in 2018. Gross profit margin improved because of the recovered utilization of the conveyor system of the Mae Moh Phase 8 project and more efficient operating costs control.

We hold our view that the landslide is a one-off event. In our base-case projection, we forecast SQ will generate revenue of THB4.2-THB4.5 billion per annum during 2021-2023. Gross profit margin is expected to stay around 21%-24%, and earnings before interest, tax, depreciation, and amortization as a percentage of revenues (EBITDA margin) to stay above 35% over the next three years. Given the burden of high interest expense, funds from operations (FFO) are forecast to range THB1.4-THB1.6 billion per year.

Narrow business scope and projects concentration

The rating is weighed down by SQ’s narrow scope of business, despite its strengths in mining. SQ could be at high risk of failing to secure new contracts at the time the existing projects are closing out. Failure to secure new projects has raised questions regarding the company’s long term business prospects.

In addition, the backlog consists of only a couple of large projects. The Mae Moh mine has generated around 70%-85% of revenue over the past five years. Currently, the largest project in the backlog is Mae Moh Phase 8, which accounts for 56% of the value of the backlog, with the rest of backlog from the Hongsa mine. If SQ significantly underperforms on any of these projects, a material adverse impact could be caused to the company’s overall financial profile.

Given the dearth of new viable mining projects in Thailand, SQ has sought opportunities abroad, raising the company’s exposure to significant country risk and counterparty risk associated with its overseas undertakings. In recent years, SQ and its Myanmar-based partner have set up a joint venture to develop and operate the Mai Khot coal mine in Shan State of Myanmar, under multi-year concessions. Due to difficulties induced by the Coronavirus Disease 2019 (COVID-19) pandemic and political unrest in Myanmar, the coal mine project is currently put on hold. We maintain our concern over the high level of country and counterparty risks associated with the project.

Leverage expected to decline

We expect SQ’s financial leverage to gradually decline from its current level over the next three years. SQ typically carries a heavy debt load at the commencement of each project, due to hefty capital expenditure for new heavy-duty machinery and equipment. We view that the high debt level is mitigated by the predictability of the revenue streams from the projects. We expect financial leverage to decline over the course of the projects.

As of March 2021, total debt was THB6.5 billion. The ratio of debt to capitalization ratio stood at 70.5% as of March 2021, a consistent decline from 73.4% as of 2020 and 77.7% as of 2019. The ratio dropped due to SQ’s recovered performance in the Mae Moh Phase 8 project. In our base-case projection, we forecast SQ’s debt to capitalization ratio to stay at 70% in 2021, before declining to range around 65% in the following two years. Such a leverage level is considered on a high side, notwithstanding the cash flow from work in progress. The ratio of FFO to debt is forecast to hold at above 20% while the debt to EBITDA ratio is expected to stay below 3.5 times.

Manageable liquidity

With the recovery in its cash flow generation, we expect SQ will prudently manage its liquidity. As of March 2021, SQ had THB221 million plus undrawn long-term project loans of about THB62 million. At the same time, debts worth THB2.2 billion will come due in the next 12 months, comprising THB680 million in short-term borrowings, THB1.2 billion in financial lease and project loans, and THB300 million in debentures. We forecast SQ will generate FFO of around THB1.3-THB1.4 billion over the next 12 months. We expect SQ will repay the project loans with internally generated cash. The company will likely refinance its maturing debentures with new debentures issuance and rollover most of its short-term loans.

With respect to the financial covenant in relation to SQ’s outstanding debentures, the company is obliged to keep the interest-bearing debt to equity ratio below 3.5 times. At the end of March 2021, this ratio was 2.45 times.

BASE-CASE ASSUMPTIONS

These are the key assumptions in TRIS Rating’s base-case forecast for 2021-2023:

- SQ’s revenue to be around THB4.2-THB4.5 billion per annum.
- EBITDA margin to hold in the 35%-40% range.
- Capital expenditure of THB2-THB2.3 billion over the next three years.

RATING OUTLOOK

The "stable" outlook embeds our expectation that SQ will maintain its competitive strengths in mining business, and that SQ will perform in accordance with the terms of the contracts and generate an acceptable level of cash flow over the course of the undertaken projects. We expect its EBITDA margin will remain above 35% while the FFO to debt ratio to stay above 20%, which will in effect, result in a steady decline in financial leverage.

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 20% 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 substantially and the debt load drops to a great extent.

COMPANY OVERVIEW

SQ was established in May 2001 by the Sirison and Areekul families, 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. SQ is currently 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 the EGAT. SQ has conducted mining operations for several phases of the Mae Moh mine over the past 35 years. The projects at the Mae Moh mine have accounted for more than 70% of the company's total annual revenue over the past three years.

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 2021, this founding family held a 25% stake in the company.

SQ's revenue has grown continually over the past few years after winning contracts for the Hongsa mine and the Mae Moh Phase 8 project. The latter is currently the largest project in the backlog. Revenue in the last two years was THB4.8 billion per annum, up from THB3.6 billion in 2018. Revenue in the first quarter of 2021 was THB1.2 billion, down 5.9% from the same period last year. The EBITDA margin held in the range of 25%-35% during 2017-2020. It rose to 46% in the first quarter of 2021.

KEY OPERATING PERFORMANCE

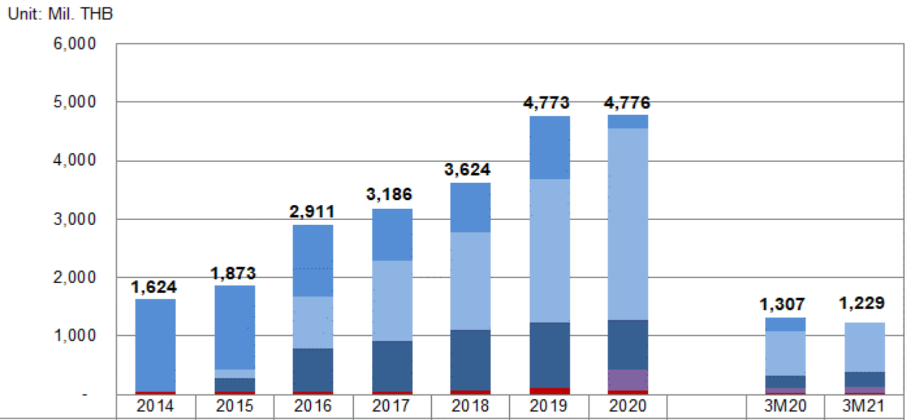
Table 1: SQ's Projects in the Backlog as of Mar 2021

Unit: Mil. THB

Projects	Duration	Backlog Value (Mil. THB)	Total (%)
Mae Moh Phase 8	2016-2025	12,191	56
Hongsa mine	2015-2026	7,701	35
O&M Hongsa	2020-2026	1,916	9
Total		**21,808**	**100**

Source: SQ

Chart 1: Revenue Breakdown



	2014	2015	2016	2017	2018	2019	2020		3M20	3M21
Mae Moh Phase 7	1,585	1,445	1,238	905	848	1,090	223		224	-
Mae Moh Phase 8	-	146	897	1,376	1,673	2,461	3,277		768	850
Hongsa	-	247	731	857	1,027	1,107	850		217	259
Hongsa O&M	-	-	-	-	-	-	353		81	97
Others	39	35	46	47	77	116	72		17	23

Source: SQ

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Mil. THB

		-------------Year Ended 31 December ----------			
	Jan-Mar 2021	2020	2019	2018	2017
Total operating revenues	1,229	4,776	4,773	3,624	3,186
Earnings before interest and taxes (EBIT)	305	545	384	(123)	575
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	562	1,648	1,562	913	1,186
Funds from operations (FFO)	518	1,342	1,179	760	974
Adjusted interest expense	69	315	389	287	137
Capital expenditures	24	310	463	2,268	4,974
Total assets	9,873	10,009	11,106	11,987	10,241
Adjusted debt	6,320	6,669	7,544	7,639	4,727
Adjusted equity	2,648	2,412	2,165	2,166	2,578
Adjusted Ratios					
EBITDA margin (%)	45.73	34.51	32.74	25.18	37.22
Pretax return on permanent capital (%)	7.06 **	5.64	3.81	(1.37)	9.14
EBITDA interest coverage (times)	8.10	5.24	4.01	3.18	8.66
Debt to EBITDA (times)	3.61 **	4.05	4.83	8.37	3.99
FFO to debt (%)	23.40 **	20.13	15.63	9.95	20.60
Debt to capitalization (%)	70.47	73.44	77.70	77.91	64.71

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

RELATED CRITERIA

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

Company Rating:	BBB-
Rating Outlook:	Stable

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