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Research Update:

PT Japfa Comfeed Downgraded To 'B+' On Weakened Cash Flows Adequacy Ratios, Capital Structure; Outlook Stable

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Overview

- Japfa's margins and cash flows are likely to remain thin over the next 12 months at least because of tough conditions in Indonesia's downstream poultry segment.
- We also expect the debt of the Indonesia-based integrated poultry producer to remain elevated, and its cash flow adequacy to remain thin.
- The weaker rupiah and Japfa's growing proportion of debt due in the next 24 months have also weakened the company's capital structure.
- We are lowering our long-term corporate credit rating on Japfa and the long-term issue rating on the company's guaranteed senior unsecured notes to 'B+' from 'BB-'. We are also affirming our 'axBB' long-term ASEAN regional scale rating on the company.
- The stable outlook reflects our expectation that Japfa's FFO-to-debt ratio will stabilize at 12%-14% over the next 12-18 months owing to tough operating conditions. We also expect the company to maintain good access to domestic banks.

Rating Action

On April 28, 2015, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on PT Japfa Comfeed Indonesia Tbk. (Japfa) to 'B+' from 'BB-'. The outlook is stable. We also lowered our long-term issue rating on the senior unsecured notes that Japfa guarantees to 'B+' from 'BB-'. At the same time, we affirmed our 'axBB' long-term ASEAN regional scale rating on the Indonesia-based integrated poultry producer.

Rationale

We lowered the ratings because we expect Japfa's margins and cash flows to remain thin over the next 12 months at least because of tough conditions in Indonesia's downstream poultry business. We also expect the company's debt to remain elevated and its cash flow adequacy to remain low over the period. A 5% depreciation of the Indonesian rupiah (IDR) this year and Japfa's growing proportion of debt maturing in the next 24 months have also weakened the company's capital structure.

We expect operating conditions in Indonesia's downstream poultry segment to remain difficult for the next 12 months at least. Years of aggressive expansion in day-old chick and commercial farming capacity have coincided with slowing growth in domestic demand. In our view, capacity cuts by domestic producers, including Japfa, will take time to translate into better pricing and a more balanced supply. Prospects for a sustained improvement in margins are also limited because companies can quickly rescale supply at a limited cost if prices improve. Finally, other large industry operators, including larger producer PT Charoen Pokphand Indonesia Tbk., are yet to meaningfully cut capacity.

In our view, lackluster growth in domestic demand is another drag on a sustainable improvement in the industry conditions because we expect consumer sentiment to be subdued for the rest of the year at least. The rise in wages has been slowing in Indonesia, and the new administration has taken a number of measures (including adjustments to the fuel subsidy regime) that have affected disposable incomes. The rupiah has started to decline again and may also indirectly hit consumer confidence. The lifting of an export ban on processed chicken to Japan earlier this year will support export demand. However, the impact on volumes is not likely to show until 2016. That said, demand fundamentals remain strong, in our view, for the next five years, given the size of the market, still low per-capita consumption, and growing wealth levels.

We project Japfa's EBITDA margins to be about 7% in 2015 and 2016, compared with 7.1% in 2014 and 10.2% in 2013. The company has also forecast tough operating conditions in the quarter ended March 31, 2015. Japfa's day-old chick operations are likely to be loss making and its commercial farming business could break even over the period. Japfa's absolute debt and interest expenses have increased substantially over the past three years to fund capital spending and have compounded the effect of lower margins on the company's cash flows adequacy ratios. We forecast that the ratio of funds from operations (FFO) to debt to be 12%-14% for the next 12-18 months, compared with 12% in 2014. This ratio is commensurate with the weaker end of our "aggressive" financial risk profile assessment.

We also expect Japfa's debt-to-EBITDA ratio to remain above 4.0x over the next 12-18 months. This level is above the maximum level the company must maintain under some of its bank loan covenants. However, we expect Japfa to obtain waivers from its lenders on the breach.

Japfa's proposed 50% reduction in capital spending to IDR750 billion in 2015 shows the company's willingness to preserve cash, in our view. However, the cut will be insufficient for the company to reduce its absolute debt level. We still forecast negative free operating flows in 2015 and 2016, and a moderate increase in debt. We also believe that the company may step up spending if industry conditions improve, instead of paying down debt.

Japfa's capital structure is a credit weakness in the context of the weakening rupiah. We estimate that about 40% of the company's debt is denominated in U.S. dollars, which makes its leverage sensitive to volatility in the rupiah. We also estimate that a little over half of the company's debt will mature within the next 24 months. This compares with about one-third of debt maturing within 24 months in 2013. The 2014 maturities include a IDR1.5 trillion bond due in January 2017 and short-term working capital lines. We expect interest costs for these short-term facilities to rise as domestic banks are tightening lending conditions. We therefore estimate that Japfa's EBITDA interest coverage will be 2.5x-2.7x in 2015 and 2016, from about 2.4x in 2014 and 4.0x in 2013.

Our base case includes the following:

- Our economists expect Indonesia's GDP to grow 5.5% in 2015 and 6.0% in 2016.
- Japfa's revenue is likely to grow about 5% in 2015 and 5%-7% in 2016. This figure is slower than our earlier estimate because the company is slowing capacity expansion and we expect volume growth to remain subdued.
- EBITDA margin will be about 7.0% in 2015 and 2016, and we assume no improvement in downstream poultry operations.
- Working capital requirements will be IDR200 billion-IDR300 billion annually.
- Capital spending is likely to be IDR750 billion-IDR800 billion in each of 2015 and 2016.

Based on these assumptions, we arrive at the following credit metrics:

- EBITDA of about IDR1.8 trillion in 2015 and about IDR1.9 trillion in 2016, compared with IDR1.8 trillion in 2014.
- Ratio of FFO to debt of 12%-14% in 2015 and 2016.
- Debt-to-EBITDA ratio of about 4.2x in 2015 and slightly above 4.0x in 2016.
- EBITDA interest coverage of 2.5x-2.7x in 2015 and 2016.
- Annual negative free operating cash flows of about IDR150 billion-IDR250 billion in 2015 and 2016.

In our view, Japfa's competitive advantage remains intact despite the tough market conditions. The company's wide geographic footprint, difficult-to-replicate distribution network, good downstream integration, and economies of scale should help it maintain its No. 2 position in Indonesia. Japfa's sizable and cash generative poultry feed business also tempers volatility in its downstream operations.

Liquidity

We view Japfa's liquidity as "less than adequate." We expect the company's ratio of liquidity sources, including cash and internal cash flows, to liquidity needs, including short-term debt and working capital, to be less than 1.0x over the next 12 months.

Japfa is in breach of a number of maintenance covenants on its bank loans as of year-end 2014. The company received waivers for those breaches. We do not expect the company to breach the relaxed covenants at year-end 2015.

Our forecast that Japfa's debt-to-EBITDA ratio will be close to 4.0x in 2016 could trigger a further breach in 2016. However, we believe the company will obtain further waivers or will repay some of these bank loans, given its established banking relationships and record of rolling over working capital lines even during difficult market conditions.

We exclude about IDR1.5 trillion in revolving working capital facilities from liquidity sources because these facilities are renewable annually.

Principal liquidity sources include:
- Cash balance of about IDR768.5 billion as of Dec. 31, 2014; and
- FFO, before changes in working capital, of about IDR950 billion over the next 12 months.

Principal liquidity uses include:
- About IDR2.5 trillion of short-term debt, most of which comprises short-term working capital loans;
- Spending of no more than IDR300 billion in a tight liquidity situation, mostly on maintenance; and
- Working capital requirements of about IDR200 billion.

Outlook

The stable outlook reflects our expectation that Japfa's FFO-to-debt ratio will stabilize at 12%-14% over the next 12-18 months. The outlook also factors in our view that Japfa will maintain good access to domestic banks and seek to extend debt maturities.

We could lower the rating if Japfa's liquidity deteriorates. This could materialize if the company does not make material progress on the refinancing of its rupiah bond within the next 12 months or if it finds it difficult to refinance maturing short-term debt at a reasonable cost. We could also lower the rating if: (1) we expect the company's FFO-to-debt ratio to stay below 12%. We believe this could materialize if the EBITDA margin deteriorates below 7.0% while the company maintains its capital spending; (2) the market position of Japfa's poultry feed and breeding operations weakens, either because of significant additional capacity or an erosion of the company's cost advantage; or (3) we assess Japfa's group credit profile to have weakened because of higher consolidated debt or increased debt at its parent company Japfa Ltd.

We are unlikely to upgrade Japfa over the next 12 months, given the tough industry conditions and compressed margins. Nevertheless, we could raise the rating if the company's cash flows improve such that its FFO-to-debt ratio rises toward 20% on a sustained basis. We believe this will likely require sustainably better operating conditions, with EBITDA margins staying above 8.5%, and a prudent approach to capital spending. An upgrade would also be contingent upon the company's debt maturity profile improving.

Ratings Score Snapshot

Corporate Credit Rating B+/Stable/--

Business risk: Fair

- Country risk: High
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Very Negative (-2 notches)
- Financial policy: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Related Criteria And Research

Related Criteria
- Key Credit Factors For The Agribusiness And Commodity Foods Industry, Jan. 29, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- National And Regional Scale Ratings, Sept. 22, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Timeliness of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 2013
- Legal Criteria: Guarantee Criteria--Structured Finance, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research
- Ratings On Indonesian Companies Will Have Less Headroom In 2015, April 5, 2015
- Japfa Outlook Revised To Negative On Tough Operating Conditions, Weaker Prospective Cash Flow; 'BB-' Rating Affirmed, Nov. 5, 2014

Ratings List

Downgraded		
	To	From
PT Japfa Comfeed Indonesia Tbk.		
Corporate Credit Rating	B+/Stable/--	BB-/Negative/--
Comfeed Finance B.V.		
Senior Unsecured	B+	BB-
Ratings Affirmed		
PT Japfa Comfeed Indonesia Tbk.		
Corporate Credit Rating		
ASEAN Regional Scale	axBB/--/--	

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