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Research Update:

PT Japfa Comfeed Downgraded To 'B' On Deteriorating Cash Flow Adequacy, Eroding Liquidity; Outlook Negative

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Overview

- We project that the margins and cash flows of Japfa will be substantially below our earlier expectation in 2015. The cash flow adequacy could also remain weak if tough conditions in Indonesia's poultry sector persist.
- Japfa's liquidity is also eroding because of weaker operating cash flows and higher short-term debt.
- 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 'B+'. We are also lowering our long-term ASEAN regional scale rating on the Indonesia-based integrated poultry producer to 'axB+' from 'axBB'.
- The negative outlook reflects Japfa's eroding liquidity and increasingly unfavorable debt maturity profile. The outlook also reflects the prospects that the company's FFO interest coverage may not recover toward 3.0x over the next 12 months if operating conditions remain tough.

Rating Action

On July 31, 2015, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on PT Japfa Comfeed Indonesia Tbk. (Japfa) to 'B' from 'B+'. The outlook is negative. We also lowered our long-term issue rating on the senior unsecured notes that Japfa guarantees to 'B' from 'B+'. At the same time, we lowered our long-term ASEAN regional scale rating on the Indonesia-based integrated poultry producer to 'axB+' from 'axBB'.

Rationale

We lowered the ratings because we expect Japfa's margins and cash flows to be substantially below our earlier expectation for the next 12 months at least.

We lowered our assessment of Japfa's stand-alone credit profile to 'b' from 'b+' because we project the company's cash flow adequacy in 2015 to be much lower than we anticipated. We forecast that Japfa's ratio of funds from operations (FFO) to debt will be 7%-9% and its FFO interest coverage will be close to 2.0x in 2015. The ratios could be less than 12% and below 3.0x in 2016, based on EBITDA margin of 5.5%-6.5% over the period. We earlier expected an FFO-to-debt ratio of 12%-14%, FFO interest coverage of close to 3.0x, and margin of about 7% for the period.

We estimate that Japfa's EBITDA margin would need to improve sustainably above 8% for the company to reduce its debt and improve the FFO-to-debt ratio comfortably above 12% and the FFO interest coverage to close to 3.0x. We believe this scenario will be challenging until at least the end of 2016, given the current tough domestic market conditions with poor demand and overcapacity. Certain supply-side adjustments from the large poultry producers may take place in the second half of 2015 and help Japfa's margins in 2016. But the timing of those adjustments, their materiality, and impact on margins is uncertain. Therefore we believe margin visibility beyond 2015 is limited.

Japfa's EBITDA was about Indonesian rupiah (IDR) 630 billion for the six months ended June 30, 2015, less than 40% of our full-year forecast. EBITDA for the second quarter, at about IDR380 billion, was about half that for the same period in 2014. EBITDA margin was at a multi-year low of about 5.1%. The second quarter is traditionally the strongest for the company.

Japfa's deteriorating operating performance and higher working capital needs have eroded its liquidity despite a substantial reduction in capital spending. The company's short-term debt rose to almost IDR3.5 trillion as of June 30, 2015, from about IDR2.5 trillion as of Dec. 31, 2014. We expect the release of working capital after the Lebaran period in July and August 2015 will reduce the debt in the third quarter.

The liquidity at Japfa Ltd., which owns 57.5% of Japfa, has also eroded, in our view. Consolidated short-term debt decreased to about US$453 million as of June 30, 2015, from about US$485.7 million as of Dec. 31, 2014. But the cash balance also declined to about US$218.2 million from about US$286.7 million over the period because of higher working capital and capital spending.

Japfa's capital structure and debt maturity profile remain credit negatives, in our view. Besides exposure to currency mismatch, depreciation in the rupiah, and elevated short-term debts, Japfa faces repayment of IDR1.5 trillion in domestic bonds in early 2017. This bond still has about 18 months to maturity and Japfa has sound access to domestic funding sources, in our view. However, persisting poor operating conditions in the domestic poultry sector could delay the refinancing of the bonds or increase the cost. A sufficiently proactive refinancing well in advance of the due date will be critical for Japfa to maintain its liquidity.

We apply our group rating methodology to Japfa because the parent has majority ownership of the company. We align the stand-alone credit profile of Japfa with the group credit profile because we view Japfa as a core subsidiary of Japfa Ltd. This is because of its large contribution to the group's consolidated revenue and EBITDA. Japfa Ltd. has provided working capital support through trade payable extension to its subsidiary in the past and we expect such support to continue if needed.

The deterioration of the group's consolidated cash flow adequacy was less severe than that of Japfa because the group has other EBITDA-producing

operations that were more resilient in the half year ended June 30, 2015. The group's consolidated reported debt also remained broadly unchanged because its operating cash flows were more robust than those of Japfa.

Our base case includes the following:

- Our economists expect Indonesia's GDP to grow 5.4% in 2015 and 5.5% in 2016.
- Consumer sentiment is likely to stay subdued till the end of 2015 at least, resulting in sluggish demand and pricing.
- Japfa's revenue is set to grow about 2% in 2015 and about 4% in 2016.
- Its EBITDA margin is likely to be 5.0%-5.5% in 2015. Supply-side adjustments from large poultry producers could improve Japfa's margin to 6%-7% in 2016, even though visibility remains poor.
- Annual working capital requirements to be about IDR200 billion.
- Annual capital spending to be IDR750 billion-IDR800 billion in 2015 and 2016.

Based on these assumptions, we arrive at the following credit metrics for Japfa:
- EBITDA of IDR1,200 billion-IDR1,300 billion in 2015 and about IDR1,700 billion in 2016.
- Ratio of FFO to debt of 7%-9% in 2015 and close to 12% in 2016.
- Debt-to-EBITDA ratio of 5.5x-6.0x in 2015 and about 4.5x in 2016.
- FFO interest coverage of about 2.0x in 2015 and 2.5x-2.8x in 2016.

Liquidity

We view Japfa's liquidity as "less than adequate." We project 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 below 1.0x over the next 12 months. In our view, the company will remain dependent on a roll over of its maturing working capital debt.

Japfa was 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 expect Japfa to breach these covenants for the next testing period. That said, the company's established banking relationships and record of rolling over working capital lines even during difficult market conditions should help it obtain further waivers or repay some bank lines.

Principal liquidity sources include:
- Cash balance of about IDR910 billion as of June 30, 2015; and
- FFO before changes in working capital of about IDR700 billion over the next 12 months.

Principal liquidity uses include:
- About IDR3.5 trillion of short-term debt, most of which comprises short-term working capital loans. We expect some of these working capital loans to be repaid in the third quarter;
- 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 negative outlook reflects Japfa's eroding liquidity and its increasingly unfavorable debt maturity profile over the next 18 months. The outlook also reflects the prospects that the company's FFO interest coverage will not recover toward 3.0x over the next 12 months if operating conditions remain tough.

We could downgrade Japfa if the company's liquidity weakens because of a failure to roll over maturing working capital debt, to proactively refinance maturing bonds or bank loans, or because of persisting covenant breaches without timely liquidity support from the group. We could also lower the rating if we lower our assessment of the group credit profile. Given Japfa's large contribution to the parent's consolidated revenues and EBITDA, we could lower the group credit profile if Japfa's FFO interest coverage fails to recover sustainably toward 3x over the next 12 months. This could materialize if the Indonesia operations remain weak, Japfa's EBITDA margin does not improve above 8.0%, and the company maintains its capital spending.

We could revise the outlook to stable if Japfa's cash flow adequacy stabilizes. We believe this would require a sustainable recovery in the consolidated ratio of FFO to debt to comfortably above 12%. A revision in the outlook would also be contingent upon a substantial lengthening of Japfa's debt maturity profile and an improvement in its liquidity.

Ratings Score Snapshot

Corporate Credit Rating: B/Negative/--

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: Neutral (no impact)

Stand-alone credit profile: b

Group credit profile: 'b'
Entity status: Core (ratings equalized with GCP)

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
- Standard & Poor's National And Regional Scale Mapping Tables, Sept. 30, 2014
- National And Regional Scale Credit 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
- 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

- PT Japfa Comfeed Downgraded To 'B+' On Weakened Cash Flows Adequacy Ratios, Capital Structure; Outlook Stable, April 28, 2015
- Ratings On Indonesian Companies Will Have Less Headroom In 2015, April 5, 2015

Ratings List

Downgraded

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

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