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Garuda Indonesia in a tight spot to make a turnaround

by Budi Andoro HARTANTO

Garuda Indonesia Persero Tbk PT (GIAA), Indonesia's national flag carrier which is around 61% government owned and mainly operates domestically, continued facing challenges as it posted a second consecutive quarterly net loss and a worsening liquidity level in Q2 2017 (see Table 1) amid a deterioration in operating performance and maturing debts. The net loss it made in Q2 2017 almost double the loss it suffered in Q1 2017. Corresponding with its worsening credit profile, the following RMI-CRI 1-Year Probability of Default (PD) for GIAA almost doubled in value and has been on an upward trend over the following period (see Figure 1).

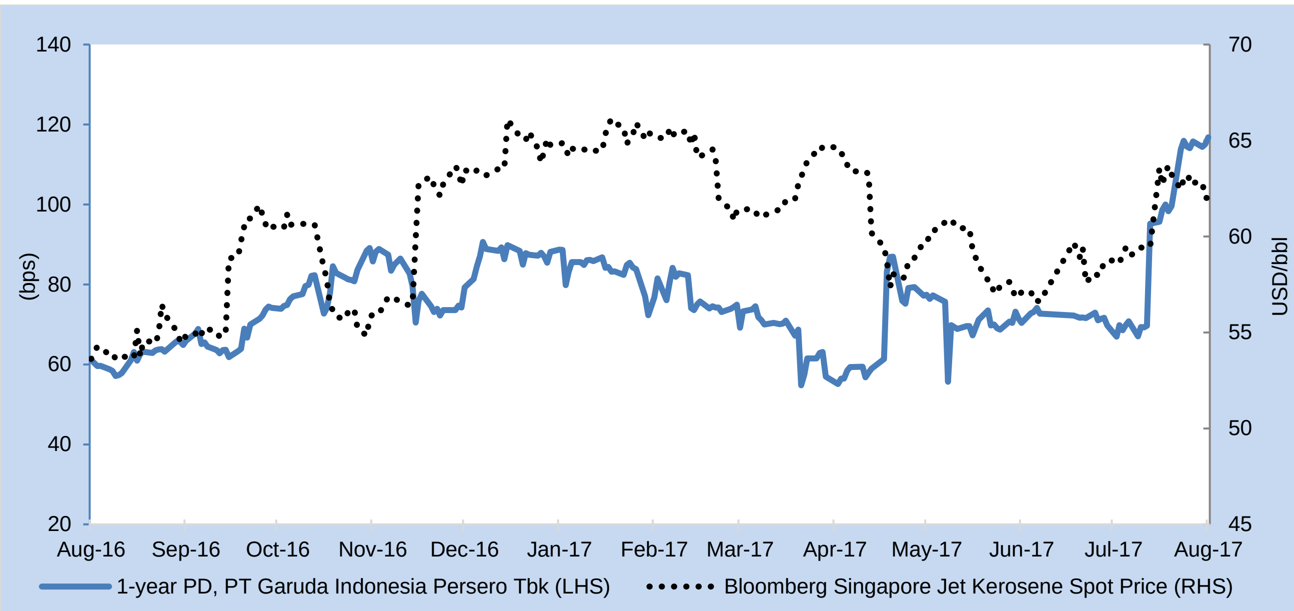

Figure 1: RMI-CRI 1-year PD for Garuda Indonesia Persero Tbk PT vs. Bloomberg Singapore Jet Kerosene Spot Price. *Source: RMI-CRI, Bloomberg*

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Revenue (USD mn)	908.0	1,101.1	998.8	909.5	977.5
Operating Expenses (USD mn)	151.8	157.9	142.5	149.9	209.6
Cash, Cash Equiv. & STI (USD mn)	537.7	462.6	578.7	546.2	378.7
Free Cash Flow (USD mn)	-29.5	106.9	8.6	-84.4	-97.7
Net Debt/EBITDA (%)	4.8	4.8	4.2	10.5	29.6
Net Debt/Equity (%)	119.3	117.8	110.4	141.2	205.2

Table 1: Financial Data for Garuda Indonesia Persero Tbk PT. *Source: Bloomberg*

In a press release by GIAA on its Q1 2017 performance, the company pointed out jet fuel price increase as one primary cause for the company losses. Based on GIAA's Q1 2017 investors presentation, fuel cost constitutes the largest percentage of operating expenses and has increased more than 50% compared to the one in Q1 2016. The Bloomberg Singapore Jet Kerosene Spot Price, a proxy for the price of jet fuel, has been increasing since Q3 2016 and surpassed the USD 62/barrel threshold in December 2016. Furthermore, it managed to retain its position at about USD 60/barrel despite the oil supply glut that happened during some time in Q1 2017.

Clinching the second place on the list of the top operating expense contributor is the cost associated with airplane rental. GIAA has been experiencing pressure on yield returns due to fleet over-capacity in markets since 2016. The situation came at a time when air traffic at many airline operators in Indonesia had been hurt by weak economy. At one time, GIAA had decided to optimize its volume and seating capacity to counterbalance low yield performance. This resulted in a passenger revenue growth (RPK or revenue passenger kilometer) of 15.2% in Q1 2017 which surpassed the capacity (ASK or available seat kilometer) growth of 10.9% on the same period. However, this positive result was overshadowed by competitions from privately owned budget airline companies like Lion Air Group and Sriwijaya Air which make up the remaining Indonesian players in the domestic airline industry. These companies have been rapidly expanding aircraft orders while keeping price lower than GIAA's.

GIAA has also been involved in a number of activities that resulted in additional costs that put pressure on its earnings. These include the recent one-off cost from the tax amnesty program by the Indonesian government and a legal cost charged by the Australia's High Court over a dispute with the Australian Competition and Consumer Commission (ACCC) on price fixing on certain air freight charges.

In response to the dismal quarterly performance, GIAA represented by the Indonesian Ministry of State-Owned Enterprise appointed a new CEO, Pahala Mansury, on April 2017. Mansury decided to implement massive changes to GIAA's business strategy, including the renegotiation of aircraft order, rental and maintenance terms to overcome the existing over-capacity problem, route optimization through proper selection of flight schedules and the kind of aircraft to use and create a price structure on consumer behavior to improve revenue performance. Markets welcomed the change, but were also becoming wary of GIAA's credit. The company currently has two debt issues: one matures in May 2018 (with a coupon rate of 9.25%, denominated in IDR and totaling IDR 2bn) and the other one in March 2020 (with a coupon rate of 5.95%, denominated in USD and totaling approximately IDR 6.68bn). The first tranche of the debt is expected to add considerable burden on GIAA's financials if the company's turnaround strategy does not yield meaningful results within the remaining 9 months, noting the fact that the debt value is roughly one-third of its cash, cash equivalents and short-term investments level (see Table 1). As for its 2020 debt, investors were greatly surprised when recently, GIAA announced that it sought consent to relax bond (sukuk) issue terms, which specify that consolidated total equity should not fall below USD 500mn and consolidated debt to equity ratio should not exceed 3X. This gave rise to the possibility that the new management's strategy might put GIAA's financials at susceptible levels. GIAA's Net Debt/Equity in Q2 2017 almost doubles if compared with that in Q4 2016 (see Table 1). Moreover, Net Debt/EBITDA in Q2 2017 almost triples over the quarter and yet Free Cash Flow continues falling into the negatives. The USD/IDR exchange rate has also been working against GIAA's favor, with its value hovering somewhere above IDR 13,300/USD after the Indonesian Rupiah depreciated rather sharply against the US Dollar in mid-November 2016. Since GIAA's 2020 debt tranche and operating expenses are denominated in USD, the situation may be tougher if the US dollar appreciates further in the future.

As GIAA is predominantly government owned, there is little chance that it would go bankrupt or default on its debts. However, with its current financials, external factors such as the decreasing mainland Chinese demand for tertiary needs (e.g. aircraft travel) after the Chinese government went on a debt crackdown are poised to create uncertainties for the company. For now, whether the new strategy will herald the company's comeback remains yet to be seen.

Credit News
Zombie firms propped up as China debt swaps surpass RMB 776bn **Aug 21.** In order to lower corporate leverage levels and clean up banks' balance sheets, China introduced guidelines for debt-to-equity swaps in October. The total value of swaps reached RMB 776bn in the second quarter when volume of the swaps hit a record high. Bloated companies, or zombie firms, were not allowed to participate in the program initially but 55% of the swaps had come from the coal and steel industries faced with overcapacity issues. These zombie firms regard debt-to-equity swaps as a way to obtain bailouts. As there is no clear definition of a zombie firm, the Chinese banking regulator looks to be addressing this issue in its guidelines released this month. Even though the swap program reduces refinancing risks for firms, there are still concerns that this strategy is unable to improve the financial health of companies. (Business Times)
Bankruptcy fight over Oncor to test Warren Buffett's discipline **Aug 20.** Berkshire Hathaway Energy has offered USD 9bn in cash for Oncor, a bankrupt Texas power transmission company and subsidiary of Energy Future Holdings. Although the rival bid by Sempra, the largest US natural gas distribution utility, is higher at USD 9.3bn, Warren Buffett had pledged not to raise his offer. Berkshire's bid has won support from key stakeholders as it accepts measures by regulators to restrict its ability to extract cash or add more debt to the acquired company. As Energy Future's biggest creditor, Elliott Management Corp opposed the sale to Berkshire as it believes the bid undervalues Oncor. Elliott has

also been trying to put together its own bid of Oncor for USD 9.3bn. The sale of Oncor will eventually need to be approved by the Delaware bankruptcy judge. (Channel NewsAsia)

Air Berlin files for bankruptcy, leaves valuable runway slots up for grabs

Aug 17. Air Berlin, Germany's second-largest airline, filed for bankruptcy protection on August 15, after its key shareholder Etihad Airway withdrew funding following years of losses. The move allows Lufthansa and other rivals an opportunity to expand business by acquiring slots at airports such as Berlin Tegel and Duesseldorf. Air Berlin has obtained a bridging loan of EUR 150mn from the government, while negotiations are ongoing and decisions are expected to be made in the coming weeks. Lufthansa, which is currently leasing planes to Air Berlin, is prepared to take on more of Air Berlin's business despite calls of breaching antitrust laws. (Business Times)

Amtek Auto urgently needs working capital, says insolvency professional

Aug 17. Flagged by the central bank for insolvency proceedings, Amtek Auto Ltd is now in urgent need of funds to run its operations. The resolution professional has sought cooperation of stakeholders to keep the company afloat and avoid any possible delisting of shares for non-payment of charges. A string of overseas acquisitions resulted in a pile of debt for the company, which stood at INR 7.8bn at the end of March 2016. Amtek Auto also owes INR 2.1bn to bondholders and overseas lenders. The car parts marker is the only large stressed account from the automobile and ancillary sector, with losses widening to INR 88.9bn in the quarter ended June as its operating margin halved on faltering sales. The company is now operating at a very low level of capacity utilization and requires immediate working capital. (Bloomberg)

Wiped-out creditors await delayed payout in debt swaps snag

Aug 16. Banco Popular Espanol's failure is testing the boundaries of Europe's new resolution regime. The bank's CDS protection buyers have not received compensation two months after the subordinated bonds were written off even though the ISDA recognized the credit event in June. The payment amount to counterparties has not been finalized and bonds of the defunct lender are still trading as investors are willing to pay for the residual rights to the company's assets. The ISDA committee held meetings with several parties but have yet to establish if the defunct bonds have a market value and have changed hands. (Bloomberg)

Singapore bank stocks battered by more O&M bad news (Business Times)

Brazil sugar group Clealco refinances nearly BRL 1bn in debt (Reuters)

Norske Skog extends recapitalisation deadline to 23 August (Euwid Pulp & Paper)

Regulatory Updates

Regulators get ready to authorize 'ringfenced' UK banks

Aug 19. Regulators have asked the largest banks to ring-fence their riskier business divisions to prevent a taxpayer's bailout when bets made by the lender's investment banking unit goes awry. UK Banks are preparing to split their core retail activities from their riskier investment banking (IB) units to comply with the new rules. Lenders with more than GBP 25bn in deposits will have to ring-fence their IB activities. There will be a new board overseeing the new entity with fixed limits to how much assets the retail and IB units can share. The Prudential Regulation Authority (PRA) has set a January 2019 deadline for banks to setup their new legal entities, which coincides with the Brexit deadline in March 2019. (FT)

China codifies crackdown on 'irrational' outbound investment

Aug 18. China imposed new rules to restrict "irrational" overseas investments ranging from property to hotel and entertainment. "Banned", "restricted", and "encouraged" are the three main categories set by authorities, who is outlawing investments in gambling and sex industries while backing companies to support projects linked to the "Belt and Road" initiative. Last year, the capital outflow reached USD 816bn before officials began to take control to stabilize the capital account and foreign exchange reserves. China experienced a 44.3% slump on outbound investments in the first seven months this year. Analysts deduced that these restrictions are part of officials' plan to prevent a rebound in capital outflows and highlighted their concerns on potential investment losses related to these ''irrational'' overseas investments. (Bloomberg)

Fed's Fischer attacks moves to unwind regulations (FT)

Insider trading schemes using encrypted apps alarm FBI (FT)

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