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Research Update:

Kuwait Projects Co. (Holding) K. S.C. Downgraded To 'BB-' And 'gcBBB-'; Outlook Negative

July 13, 2021

Rating Action Overview

- Despite a sizable capital injection in 2019, Kuwait Projects Co. (Holding) K.S.C.'s (KIPCO's) leverage continued to increase markedly, while its investment performance remained weak. Two of its largest companies, OSN and UGH (both, unrated), reported large losses and received capital injections in 2020. Consequently, we revised our investment position assessment and business risk profile for KIPCO to weak.
- KIPCO will face large maturities in 2023, and its cash flow from investments is likely to remain muted over this time. Although we foresee no immediate liquidity pressure, we no longer see its financial policy as more favorable than peers'. We therefore negatively reassessed the group's liquidity to adequate from strong.
- We therefore lowered our long-term issuer credit rating on KIPCO to 'BB-' from 'BB', and our Gulf Cooperation Council regional scale rating to 'gcBBB-' from 'gcBBB+'.
- As of March 31, 2021, our adjusted loan-to-value (LTV) for KIPCO is well above the 60% threshold. We continue to assume some capital injection from the shareholder to soften a more pronounced erosion of the LTV profile, but it may not be sufficient for a sustainable improvement. Conversely, in absence of such support, we see the potential risk of a more than one notch negative rating action.
- The negative outlook predominantly reflects our view of significant continued pressure on KIPCO's LTV and its portfolio credit quality given the weak performance of its key portfolio companies. Furthermore, the absence of shareholder support to ease the pressure on the LTV profile would indicate the potential for a multi-notch downgrade.

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Rating Action Rationale

The low performance of key portfolio companies has weighed materially on KIPCO's leverage, cash flow, and average portfolio credit quality over the past few years. We've considered the continued sluggishness of these assets, alongside the group's weak track record of investment and dividend returns, increasing leverage, negative progress of KIPCO's net asset value generation, and lack of portfolio rotation outside intragroup transactions over the recent years.

The combined impact causes us to reassess KIPCO's investment position and its business risk profile as weak, versus fair previously.

KIPCO has struggled with the performance of some of its key assets over the past years. Among its largest assets, OSN (26% of KIPCO's reported portfolio value) reported positive net income for three years only between 2011 and 2020 while receiving multiple capital injections. Similarly, United Gulf Holding (UGH; 22% of KIPCO's reported portfolio value) operated with very limited earnings, without generating any meaningful dividends. Conversely, Burgan Bank (23% of KIPCO's reported portfolio value) and Gulf Insurance Group (5%) were the only large assets to consistently perform well over 2011-2020.

KIPCO's leverage has suffered despite shareholder help in 2019. The group's reported loan-to-value (LTV) ratio deteriorated to 46.8% as of March 31, 2021, despite a $312 million cash injection by KIPCO's main shareholder in 2019, from around 25% at end-2016. Very weak investment performance of some of the key assets, limited dividend income relative to KIPCO's funding and operating costs, and large capital injections to support OSN drove the decline. In 2020, the picture worsened further. Burgan Bank, the group's biggest earner, saw its net income shrink by 60%. Additionally, UGH reported over $70 million in losses, prompting KIPCO to inject capital in December 2020. Moreover, United Real Estate reported its third consecutive year of losses, and OSN continued to report negative results while receiving additional capital from KIPCO.

UGH remains loss making as of end-March, and its recovery prospects are unclear KIPCO has a 93.3% effective stake at UGH, an investment holding company with around $3.3 billion in assets listed on the Bahraini Stock Exchange. With a free float of around 7%, UGH shares are rarely traded, and according to its last share price dated September 2018, UGH has a market capitalization of $1.5 billion, despite no meaningful income generation. This implies a 6.9x price to tangible book for UGH versus an average 1.2x–1.3x for a sample of highly profitable, actively traded banks in Gulf Cooperation Council (GCC) countries. We don't think this premium is justified, since neither the valuation is validated by real trading volumes nor UGH's historically low returns, which are now on deep negative territory. Therefore, we now value this asset based on UGH's end-March tangible book value, which translates to a $105 million value for KIPCO's 50.2% stake.

UGH incurred large write-downs in 2020 and received a capital injection from KIPCO at year-end. As of March 31, 2021, UGH has a tangible equity attributable to parent of around $210 million versus consolidated assets of $3.4 billion and $3.6 million losses for the first quarter. At this point, we question UGH's ability to operate sustainably on a stand-alone basis without KIPCO's support, and while this is not management's guidance, we do not rule out potential additional capital needs at UGH in the near future.

These developments continue to constrain the credit quality of KIPCO's portfolio. The group's average portfolio credit quality falls into the low end of our 'BB' rating category. This, together with high portfolio concentration, weighs on the group's business risk profile. If KIPCO cannot revive the performance of its key assets and deterioration persists, the creditworthiness of its portfolio would slip further, intensifying the pressure on KIPCO's business risk profile.

OSN continues to operate with losses, and there haven't been visible developments in KIPCO's efforts to find a strategic partner. The current reported valuation of $1.5 billion for OSN dates from 2009, when OSN was formed from the merger of two operators in the region. On November 2018, KIPCO announced its search for a strategic partner for OSN via a partial stake sale. We have not seen any tangible progress on this transaction to date, and the management now guides for a potential transaction in 2022. While our existing haircuts remain unchanged at this stage, we might incorporate further substantial haircuts if we do not see a meaningful return to profitability by year-end, in addition to substantial EBITDA generation prospects in the future.

The pending capital injection helps, but it is unlikely to resolve KIPCO's fundamental problems. We also believe shareholder support will become a more common feature going forward as large maturities start in 2023. KIPCO reported a 46.8% LTV at March 30, 2021, while our haircuts to its OSN and UGH valuations mean S&P Global Ratings-adjusted LTV is visibly higher than the 60% threshold. In the meantime, we continue to assess financial risk as aggressive, reflecting an anticipated capital injection from its shareholder Al Futtooh Group (AFH) before end-2021. This will be the second capital raising since 2019. We consider the injection to be likely, given the shareholder's historically supportive stance, and this is a credit positive. In our view, the capital support will help, but we doubt it will fundamentally and sustainably solve the increasing leverage issue the company has faced for some time. Indeed, and regardless the operating outlook on UGH and OSN, we do not rule out future capital calls or write-downs at the level of these assets that would strain KIPCO's already very high leverage levels. In the absence of a major recovery in portfolio performance, a large asset monetization, or another substantial capital injection, we believe it will be hard for KIPCO to improve its LTV ratio comfortably below 60% over the next 12-18 months. In fact, given KIPCO's structural issues and its bond maturities starting in 2023, we believe KIPCO might need to raise equity again before end-2023.

Large maturities coming due in 2023, low cash from investments, and required capital injections into key assets in 2021 prompted us to assess the group's liquidity as adequate from strong previously. KIPCO guides for a cash balance of $724 million as of March 31, 2021. It has $66 million in maturities over the next 12 months, $830 million coming due in 2023, and $330 million due in 2024. Additional pressure comes from our belief that the group will continue to operate with dividend and interest income much lower than its funding costs and operating expenses. Furthermore, the group plans to inject around $125 million into its portfolio assets in 2021. Even if we exclude potential for additional capital calls from key assets in 2022, and we assume a sizable capital injection to KIPCO in 2021, there is an increasing risk KIPCO may no longer have positive cash balances by end-2023, absent a large asset monetization such as a stake sale at OSN to non-related parties, or further capital raising. Even if we consider there is no liquidity pressure in the next 12-18 months, the structural liquidity profile gradually weakens, considering the large debt repayments of 2023 and weak cash flow in between. Therefore, we now assess KIPCO's liquidity as adequate rather than strong.

The group's track record of execution, risk management, and portfolio rotation has weakened markedly over the past few years, in our opinion. As such, we now consider the group's management and governance score to be fair, versus satisfactory previously. While KIPCO continues to operate with an experienced and stable team, we believe over the past few years the group's track record has visibly weakened in areas such as its organizational effectiveness, risk management, and ability to deploy and execute strategies to turnaround the performance of its key assets, and alleviate the pressure on the parent company.

The group's comparability with peers is weakening. We recognize the track record of support from the main shareholder AFH by incorporating a one-notch uplift to the rating on KIPCO. This reflects our view of the supportive shareholder as a permanent positive credit feature, which protects the company from a marked and sudden deterioration of its credit profile. We believe

KIPCO might need another injection over the next two years and believe support may come at some stage. In the meantime, the financial performance and valuation of KIPCO's key assets are also becoming a structural concern relative to other investment holding companies we rate. If we were to change our comparable rating analysis to neutral, this would mean further pressure on the rating.

Outlook

The negative outlook reflects continued strain on KIPCO's already weak portfolio quality, as well as its LTV ratio standing well above the level we see commensurate with the rating. We believe this pressure is unlikely to abate in 2021, even if some shareholder support temporarily relieves some of the rating pressure.

Downside scenario

We could lower the ratings if KIPCO by two notches if the company is unable to manage its LTV ratio comfortably below the 60% threshold before end-2021 via different means. Alternatively, we could downgrade KIPCO by one notch if its portfolio credit quality weakens further.

We could also downgrade KIPCO if we perceive a lower likelihood of shareholder support or if we change our comparable rating analysis to neutral as a result of continued weakness versus peers.

Upside scenario

An upgrade is remote at this stage. We would revise the outlook to stable if KIPCO reduces the LTV ratio to a level comfortably below 60% over the next six months. This would hinge on a combination of a very large capital increase and a large asset monetization at favorable terms. At the same time, we would also need to observe a significant recovery in OSN's and UGH's financial performance and KIPCO's cash flow from its investments.

Company Description

KIPCO is AFH's majority-owned operating holding company, which is connected to Kuwait's ruling Al Sabah family, with substantial investments in financial services, media, and real estate across the Middle East and North Africa region. We continue to expect that KIPCO will receive financial support from AFH when needed, as it has on several occasions in the past. In late 2011, for example, KIPCO received a $101 million cash injection from AFH that helped the company maintain its LTV target of 30%, while AFH also supported the $312 million rights offering in 2019.

Our Base-Case Scenario

Assumptions

- Cumulative dividend inflows of $100 million-$110 million in total for 2021–2022, with some downside risk.
- A cumulative dividend payout of about $20 million for 2021 and 2022.

- Operating and funding costs of $150 million per year.

Key metrics

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

- Cash flow adequacy of 0.3x in 2021 and 0.4x in 2022. Although this remains below our 0.7x threshold, given KIPCO's significant cash balances, it is not a negative rating factor at this stage.
- An LTV ratio below 60% before Dec. 31, 2021, subject to large sized capital injection before year-end. We expect that AFH will provide further support if KIPCO's LTV ratio is sustainably above 60%.

Liquidity

We view KIPCO's liquidity as adequate. We believe the company's sources of cash should cover uses by over 1.5x during the 12 months started March 31, 2021, and, subject to a large capital injection, over 1.0x during the 24 months from the same date. We note that additional unexpected capital injections into companies such as UGH and OSN could change this picture. We also view KIPCO's ability to absorb unexpected liquidity events as strained, given its very limited dividend income generation.

More importantly, our current 24-month horizon only captures the period until March 2023, which includes their $500 million bond payment, while KIPCO has another $330 million payment in November 2023. Since KIPCO's dividend and interest income has been around half of its operating expenses and funding costs for the past few years, we believe the $830 million total maturity in 2023 means KIPCO will potentially have negative cash by end-2023, unless it raises another round of equity, issue new debt or realize a major asset sale before then.

Principal Liquidity Sources:

- Parent company cash and cash equivalents of over $724 million on March 31, 2021 as per KIPCO management
- $23 million in marketable securities, and no committed lines
- Cumulative dividends and fees from portfolio companies of close to $110 million–$120 million for 2021-2022.
- Sizable capital injection by the parent in 2021.

Principal Liquidity Uses:

- $66 million bank repayment over the next 12 months and $500 million bond payment in March 2023.
- Parent company dividends of approximately $10 million per year.
- Additional total capital injection of around $125 million into investee assets in 2021.
- While we have not incorporated any additional capital injections to key portfolio companies in 2023 and 2023, we believe such cash outflows are quite probable.
- Operating and interest costs of about $150 million per year.

Issue Ratings - Subordination Risk Analysis

Capital structure

KIPCO's capital structure comprises about $2.2 billion of senior unsecured debt, of which about $1.5 billion was issued by Kuwait Projects Co. SPC Ltd. and is guaranteed by KIPCO; and $650 million is local currency Kuwait bonds, also senior unsecured and issued by KIPCO.

Analytical conclusions

The issue rating on KIPCO's notes is 'BB-', in line with the long-term issuer credit rating, because there are no significant elements of subordination risk present in KIPCO's capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Negative/B

Gulf Cooperation Council Regional Scale Rating: gcBBB-/--/--

Business risk: Weak

- Country risk: Moderately high
- Industry risk: Intermediate
- Investment position: Weak

Financial risk: Aggressive

- Leverage/Cash flow: Aggressive
- Funding and capital structure: Neutral

Anchor: b+

Modifiers

- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bb-

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | Industrials: Methodology: Investment Holding Companies, Dec. 1, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

	To	From
Kuwait Projects Co. (Holding) K.S.C.		
Issuer Credit Rating	BB-/Negative/B	BB/Negative/B
Gulf Cooperation Council Regional Scale	gcBBB-/--/--	gcBBB+/--/--
Kuwait Projects Co SPC Ltd		
Kuwait Projects Co. (Cayman)		
Senior Unsecured	BB-	BB