National Central Cooling Co. (PJSC)
(DFM: TABREED)

First Half 2020
Earnings Conference Call Transcript

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<u>Tabreed Participants:</u>
Adel Salem Al Wahedi, Chief Financial Officer
Richard Rose, Senior Vice President – Finance
Souad Jamal AlSerkal, Vice President – Strategic Communications

Presentation

Operator

Ladies and gentlemen, welcome to Tabreed's Second Quarter 2020 Earnings Call. I hand over the call to your host, Ms. Souad Jamal Al Serkal, Vice President, Strategic Communications. Madam, please go ahead.

Souad Al Serkal

Hello. Again, this is Souad Jamal Al Serkal, Vice President of Strategic Communications at Tabreed. On behalf of Tabreed's management team, I would like to welcome you all, and thank you for joining us for the second quarter 2020 results conference call. Hope you are all keeping safe and healthy. Given we are all working remotely, kindly excuse us for any technical issues on the call.

Before we begin our presentation, I would like to remind you that some of the statements made in today's conference call may be forward-looking in nature and may involve risks and uncertainties. Kindly refer to slide two of the presentation for the detailed disclaimer.

I would now request you to turn to slide three for today's agenda.

On today's call, we have with us Mr. Adel Al Wahedi, Chief Financial Officer, and Richard Rose, Senior Vice President of Finance. Adel will first provide an overview of the second quarter 2020 performance and key events. Following that, Richard will discuss the financial performance in more detail. Adel will then conclude the presentation, and we will open the lines for your questions. Thank you, and over to you, Adel.

Adel Al Wahedi

Thank you, Souad, and thank you, everyone, for joining us today. Before moving to the performance update, I would like to inform that the integration of Downtown District Cooling acquisition is largely completed and as per schedule. Also, our overall operations have been normal despite the limited workforce availability and COVID-19 preventive measures undertaken.

I would like to begin with highlighting our first half 2020 performance. Despite the COVID-19 scenario, chilled water business grew by 7.4% and total revenue grew by 5.7%. During the same period, EBITDA growth was 13.5%, and as a result, our EBITDA margin expanded from 54% of last year, the same period, to 59%. Net profit during the first half increased by 12.5%, and margin improved from 30% to 32% of this year. On an organic basis, connected capacity addition during the first half was 13,262 tons. We remain positive about our outlook and confident of achieving our target of delivering 75,000 RTs of new capacity over 2020 and 2021.

Moving to the next slide, please. Tabreed is contributing to the region's growth through efficient and environmentally friendly cooling, enabling sustainable development. As our business grows, so does our positive environmental footprint. We currently operate 83 plants across the region, delivering about 1.35 million tons of cooling. Our operations saved over 2 billion kilowatt hours of energy consumption in 2019, enough to power 117,000 homes for a year and equivalent to reducing over 1.2 million tons of CO_2 emissions. Next slide.

Tabreed is the only publicly traded and regional district cooling company in the world. The UAE is our base of operations where we have a presence in six Emirates providing 947,000 tons of cooling to our customers through 70 plants, and this is including three plants of Downtown, Dubai. This transformational acquisition significantly enhances our market positioning in Dubai, the largest district cooling market in the world.

In addition to the UAE, we work with key strategic partners in four other GCC countries. We have a total of 13 plants outside UAE providing around 400,000 tons of cooling to customers. Around 70% of our capacity is consolidated, while the rest is equity accounted as associates or JV.

Moving to the next slide. This slide outlines our capacity growth trends across the region. At the beginning of 2020, we announced that we expected to add at least 75,000 RTs of new connected capacity by end of 2021. During the first half of this year, we added 13,200 RTs of capacity across the region. Of this capacity, 6,300 RTs were added to the consolidated level and 6,800 RTs through JVs and associates. This is over and above the 150,000 RTs added on acquisition of Downtime Dubai district cooling assets from Emaar Group.

Tabreed continues to demonstrate its ability to deliver a steady increase in connected capacity in the region, driven by growth in our key markets across the GCC and by successfully leveraging our regional network to take advantage of commercial opportunities as and when they present themselves. The next slide.

This slide recaps the evolution of our performance over the years. To summarize it, Tabreed is a stable utility infrastructure business with long-term contracts with high-profile customers. This provides us clear visibility of future earnings and cash flows. We currently have 90% of capacity contracted for at least the next 10 years. About 80% of our revenues are derived from fully government-owned and partially government-owned organizations, therefore, limiting the counterparties. Tabreed has a track record of delivering profitable growth. EBITDA has increased by 10% per year since 2017.

Our acquisition of Dubai Downtown District Cooling assets and the concession agreement with Emaar Group is a significant step towards penetrating the largest district cooling market in the world.

I would like to reiterate that about the resilient business model of Tabreed, which is evident from our performance of the first half of this year despite the prevailing turbulent times. Given the utility nature of our services, there is limited direct impact of COVID-19 on our business. I will now hand over to Richard to talk about our financial results in more detail. To you, Richard.

Richard Rose

Thank you, Adel. Let me start by highlighting the key points on our income statement for the first half of 2020. Total revenue grew by 5.7%, primarily driven by chilled water business. Chilled water revenue itself increased by 7.4% on the same period last year, and key factors driving that movement were the acquisition of Downtown DCP, which added 12%, and the new capacities that Adel's described added 1%. These additions were partially offset by an increase in finance lease amortization driven by that negative CPI from last year and some volume impact due to COVID-19.

Value chain business revenue was down but accounted for only 4% of consolidated revenues and less than 1% of EBITDA. VCB's are noncore business and continue to be profitable. EBITDA the first half of the year grew by 13.5%, again reflecting the acquisition of the Downtown cooling plants. Finance cost for the period was higher due to the debt incurred to acquire Downtown DCP.

During the period, the group signed an amended agreement with an existing customer, which removed CPI indexation from the contract and extended the term of that contract by three years. This resulting difference is recorded as a finance lease modification gain by the group under other gains and losses.

The shared results of associates and JVs was lower due to subdued performance by some of our equity accounted entities and a one-off gain received in the first half of 2019 that was not repeated so far in 2020. Overall, net income increased by 12.5%.

We will now look at the statement of financial position on the next slide. Significant movements in the balance sheet as at the 30 June this year compared to the end of last year were broadly attributable to Downtown DCP consolidation. This consolidation increased fixed assets and debt significantly as well as increasing equity and reserves due to the recognition of non-controlling interests. The increase in receivables is also primarily due to downtown DCP consolidation. Receipts in the quarter from major customers have improved significantly when compared to Q1.

Turning to the next slide, I will now look at the cash flow statement. Cash flow from operating activities was down 11% on prior year. However, that is a significant improvement over Q1 when we were down almost 80%. Cash collections in Q2 were generally strong with our major customers contributing well. Given the current difficult economic scenario, cash flow generation during the period has been encouraging and DSOs remain under control.

Capital expenditure reflects the acquisition of Downtown DCP, which also explains the movement on debt servicing, and the balance in "others" primarily reflects dividends paid to shareholders. Our cash-generating ability remains resilient, driven by our long-term for our certain contracts.

Let me now turn to our normal summary of debt and return ratios. So, this slide provides the usual background on Tabreed's debt portfolio as at June this year. Tabreed has AED 5.5 billion of net debt and a gearing ratio of 51%. As you are aware, the acquisition of Downtown Dubai District Cooling was 100% financed with a fully underwritten corporate facility with a tenure of five years and 100% bullet payment of maturity. This facility does allow penalty-free prepayments, which will allow Tabreed to manage refinancing risk over the life of the facility, and it will be our intention to refinance the term loans before the Sukuk repayment becomes due in 2025.

We are confident that our resilient cash flows will enable us to manage the leverage profile and bring it back in line with the guidance provided by the rating agencies during 2021. Tabreed continues to enjoy investment-grade status with both Fitch and Moody's.

That completes the detailed review of our results for the first half of 2020, and I will now pass back to Adel for closing comments.

Adel Al Wahedi

Thank you, Richard. Before we open the line for Q&A, let me make a few closing comments. As a stable utility business model, Tabreed continues to deliver strong financial and operational performance with rising profitability and stable margins. We had a strong start to the year with strong organic growth and a very strategic transformational acquisition. Tabreed has a flexible capital structure to fund future growth. As we have mentioned before, we will look at the opportunities within and beyond GCC, and we will provide you with updates as and when such opportunities materialize.

Today, Tabreed is stronger than ever before. We have a stronger shareholder base and a management team with significant industry experience. We are working on various fronts from business development to operations to help drive growth and improve profitability. I will now request the operator to open lines for Q&A.

Questions & Answers

Operator

Our first question comes from Jonathan Milan from Waha Capital. Please go ahead.

Jonathan Milan

Regarding the comments on potential further acquisitions, from a debt-to-capital perspective or net debt to EBITDA, what would you consider to be the ceiling for Tabreed's leverage? And when it comes to valuation metrics, would you be looking at something similar to the recent acquisition, whereby, arguably, on current multiples, it's expensive but could end up being cheap once utilization ramps up. Thank you.

Richard Rose

I think we don't see that there is a ceiling for our ability to continue to grow and expand. I think we do have some capacity within the current business. We monitor and track the metrics that the rating agencies use for our investment-grade status, which is extremely important to us, and obviously, we are going to continue to maintain that. So, I think it's very difficult to say that there is a particular value that we have available on our war chest. We certainly believe that we have capacity for further acquisitions and that the new facilities would be forthcoming from the banking community to finance such acquisitions.

I think in terms of return metrics, I hear what you are saying. The Downtown transaction was an extremely strategically important transaction to us, and we are delighted with the way that, that has gone. The integration of that business into the Tabreed business has been extremely smooth and was successful despite all the issues around COVID and the pandemic. I think we would expect to see similar sorts of multiples, maybe slightly improved multiples, on any further future acquisitions.

Jonathan Milan

So similar or cheaper multiples on future acquisitions, I mean, you had better multiples. But when I was talking about the ceiling, I was thinking about the debt. So today, it's AED 5.8 billion for an EBITDA of, say, AED 750 million or AED 800 million as Dubai entity ramps up. What is the ceiling in terms of dirham debt? That's what I'm trying to get to, debt to capital, debt to EBITDA. What's the ceiling in that sense? How many more billion dirhams of debt would you take for acquisitions?

Richard Rose

I think with any new acquisition, we are acquiring new EBITDA. So it depends on that multiple as to how much additional debt we could take on. I don't think I can give a specific number, a specific dirham balance on that because it depends how much EBITDA that we're acquiring. And with any acquisition, and you'll see it with the Downtown acquisition, there's always an element you're acquiring immediately and an element which is going to come with future connections to that network or that system that you're acquiring. So I think it's a simple question, but I think it's a very complex answer, and I'm not sure I can give any precise number on it.

Jonathan Milan

Fair enough. And last thing on the acquisition. Is it UAE-focused? Or would you consider acquisitions outside of the UAE?

Richard Rose

I think in the past, we have made it clear that we do have ambitions to grow beyond our current footprint, and that continues to be the case. However, having said that, I think that we do see opportunities in the UAE as well. So I think that we are hopeful of both.

Operator

Next we have Hazem Al-Jabaly from AB Invest. You may begin the question sir.

Hazem Al-Jabaly

My question is about the amendment of the contract. Can I ask why was the contract amended? And how does the amendment benefit Tabreed?

Richard Rose

So we have amended a contract with one of our major customers. The contract has been extended by a period of just over three years, and CPI escalation has been removed from the contract. So it benefits Tabreed because the contract is extended. However, the counter to that is the CPI escalation has been removed. That contract is treated as a finance lease in our financial statements, and those changes under the standards mean that the existing finance lease was extinguished, and a new finance lease is created. And in making those accounting adjustments, a one-off gain comes out of those numbers, which is the gain that you are seeing in the financial statements.

Operator

Our next question comes from Michel Said from CI Capital. You may begin your question.

Michel Said

I had a first question regarding the income from associates and JV. My understanding that it is mainly we're talking about Qatar and Saudi. So I wanted to understand what happened there different from what's happening in UAE in terms of COVID and slowdown or in terms of type of contract which resulted in the decline in income.

Richard Rose

I think it is not just Qatar and Saudi. There are a number of JVs and associates, both within the UAE and in the regions. But you are right, those two do form part of that group. I think that we are seeing some reduction in performance, in Qatar in particular. I think there are some discounts which have been offered there to customers which we haven't reflected across the rest of the group to customers. And the other major movement that we see in this shared results is a one-off gain, which was recorded on a UAE joint venture last year in the first half of 2019, which isn't repeated again this year. So that is affecting the comparison year-on-year as well.

Michel Said

And it is something to expect in the coming quarter? I'm talking about the performance of Qatar.

Richard Rose

I think it's difficult to say. I think that's like asking me whether the COVID situation is going to continue or not. I think it's very difficult to say. It's a very solid business, the Qatar business. It's very cash-generative, just like all of our district cooling businesses across the region. So I think it's difficult to say that we'd expect to see exactly the same trend in the future quarter.

Michel Said

I have a couple of small follow-up questions on the acquisition and the amendment of the contract. So on the acquisition plan, our understanding is that given the leverage, the group's leverage currently, so are you just focused on brownfield. So it's no way now to go in Egypt or India and start with greenfield with potential earnings in a couple of years, given the leverage and given that you would like to have an EBITDA coming from a facility up and running. Am I correct? We still can be seeing a Greenfield acquisition or establish a purely new plant in Egypt or India?

Richard Rose

We continue to explore both Greenfield and brownfield opportunities. I think it is safe to say that Greenfield is not as common at the moment in the UAE, but there are Greenfield opportunities in the region that we continue to operate in now as well as in Egypt, India and some other countries as well. I understand your question, I think that it depends upon the exact structure of the Greenfield opportunities and how we finance that as to the impact on the business, but we do continue to explore Greenfield opportunities.

Michel Said

Last question, if I may. Regarding the amendment of the contract, I just wanted to understand, was it upon the request of the client? Or it's just a contract that reached maturity and you were just re-signing a new contract? And it was your decision as Tabreed to remove the indexation of CPI or… I just want to understand how it's… Or is this something to expect for other contract reaching maturity? Or it's just a one-off thing based on the relation of specific contracts on a specific plan?

Richard Rose

So this is an amendment to an existing contract. It's not a renewal of a contract on maturity. And this isn't something that I would anticipate that we would see on other contracts. Certainly, this was not driven by Tabreed.

Operator

Our next question comes from Yawar Saeed from Shuaa Securities. You may now begin the question.

Yawar Saeed

Firstly, my question is on the revenues for second quarter. In April, in your disclosure, the Dubai district cooling had a revenue of around AED 375 million in 2019 and 134,000 RTs and it has increased to 150,000 RTs. Now as we had projected on that basis, the revenue addition from Dubai assets should have been around AED 80-90 million, but the -- and the revenue increase in second quarter y-o-y is only 40 million. And why is it? And was it impacted by this COVID-19?

Richard Rose

So I think I said in my commentary on the income statement that there were a number of factors impacting the revenue, and one of those was the impact of CPI and finance lease, which is a noncash transaction, which, because the CPI was negative, has a downward impact on revenues but doesn't affect EBITDA or cash-generating ability. I think the revenues from Downtown District Cooling in the quarter, for a start, they were pretty much there for the full quarter but not every single day of the quarter. I think the consolidation, we lost a week in April from that position. And then I think there were, as you would expect, some volume reductions in the quarter within that area of Dubai because of the pandemic situation. So I think I'm not going to go into precise numbers from the contribution of Downtown DCP, but it wasn't far short of the lower end of your estimate for the quarter.

Yawar Saeed

So do you expect these numbers to ramp up to the numbers which were posted in 2019?

Richard Rose

We expect to see volumes recover. And yes, therefore, we would expect to see the numbers ramp up, as you say. And then as new volumes are added, then obviously, go on from there.

Yawar Saeed

My second question is on margins, gross margins, as you see on cost of sales. What has happened that despite the fact that Dubai assets were added, which have a higher margin as per your disclosure, that the gross margin y-o-y has decreased at around 180 bps? Why is it? And what are the one-off costs included in the cost of sales or why did margins decline?

Richard Rose
I think we always see some variation, small variations in gross margin from quarter-to-quarter. I don't think there's anything in particular that's happening here in these numbers that should continue into future quarters or create any concern. I think I'd need to look in detail at exactly the breakup of the costs and so on, but I can say that there's nothing here which is unusual in any way. We always see some variation quarter-to-quarter. This volume mix is going to have an impact because the margin on consumption is different to the margin on capacity. And particularly with the pandemic situation, the mix of capacity to consumption revenues from this year to last year will have changed, and that may be having some impact.

Yawar Saeed
And another question on finance cost. Finance costs have like hardly increased by around 10 million to 12 million, around AED 12 million for the quarter and while the debt has increased almost double. And I was expecting the finance was to be around AED 70 million, but why it's only around AED 53 million? And it looks like cost of financing has gone down. Any explanation on this?

Richard Rose
There's two significant differences in finance cost for the first half of last year to the first half of this year. The first one, you rightly point out, is we have significantly more debt following the acquisition of Downtown DCP. But secondly, the interest rates, I think, are at pretty much all-time lows and the debt we have is essentially floating. We have fixed some of it, but we fixed it in this quarter. So we see, I think, very low interest rates, which is bringing down the cost of debt.

Yawar Saeed
So can we expect this rate to continue for the coming quarters? Interest rate?

Richard Rose
Broadly, yes, I would think so. I mean, as I say, we have fixed our interest rate exposure from last year when I think we were almost entirely floating. So this year, we have fixed our exposure on the old legacy transaction from 2018 entirely. And we partially hedged our exposure on the Downtown facility that we took out in April. So therefore, I would say that, that I would expect that trend to continue, yes.

Yawar Saeed
On impairments, on the AED 10 million impairment, was it related to any specific client or it's a general impairment?

Richard Rose
I think that's just coming from the kind of routine, very mechanical calculation of IFRS 9 provisions that are required now. So I think in Q1, we made it clear that we had made provisions against COVID of around AED10 million in the quarter, and we've added to that slightly in Q2, but it's just provisions. We haven't incurred any actual losses, and we're very

hopeful that we won't. But I think it's only prudent in these circumstances and in this unique situation of a pandemic that we make some provisions.

Yawar Saeed

Last question is on balance sheet or consolidation of the Dubai assets. Tabreed's own assets, before the acquisition, they were mainly focused on this PPE and financing lease receivables. So what has happened with the consolidation of it, which in fact the intangible assets have grown significantly and they are customer contracts? What's the difference between Tabreed's own assets before the acquisition modeling for them, accounting for them and then the Dubai assets? Because this is like now intangibles have all of a sudden grown. We were expecting PPEs to grow.

Richard Rose

The requirement under the accounting standards is we have to do a purchase price allocation, and we have to allocate the cost of the acquisition to the assets that we've acquired, and you can't allocate all of that cost to PPE. There are various ways that you can value that replacement cost, amortize replacement costs, etc. So there's a limit to how much of the acquisition price can be allocated to PPE. What we have really purchased here is customer contracts, very long-term customer contracts, and therefore, a significant element of the valuation does go against that. So that's the nature of acquisition accounting, I think, versus the rest of our business, which has largely been organically growing in nature rather than through M&A.

Operator

There are no further questions in the conference call. I will now give back the floor to the company. Thank you.

Souad Al Serkal

And this concludes our Second Quarter Earnings Call. So we look forward to interacting with you with our earning calls and conference calls in the future. Should you have any further questions, please do not hesitate to contact us. Have a great day and thank you once again for joining this call.

Note: This transcript has been edited to improve readability

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