Asia Credit Research

Nam Cheong Ltd: Credit Update

Thursday, 07 January 2016

Seeking Leeway

- **Running out of room**: During our last credit update on NCL[1], we noted that NCL's interest coverage (EBITDA / interest) covenant looked tight, and that given the tough environment, meeting the covenant could be a challenge (especially with NCL requiring to factor in capitalized interest as part of the calculation). Sure enough, with the next test period (2H2015) looming and full-year 2015 results to be published early February, on 05/01/16 NCL initiated a consent solicitation exercise to obtain some waivers and financial flexibility.

- **Similar terms**: Like several other offshore marine issuers who have sought to amend their covenants, NCL is seeking to include a cure mechanism to allow NCL to avoid technical default, should NCL fail its interest coverage covenant. NCL is also seeking a waiver for any non-compliance of the interest coverage covenant for the six-month test period ending December 2015 (NCL is still currently preparing 4Q2015 / FY2015 financial statements). A summary of the cure mechanism is as follows:

Before 30/07/17:
- Interest coverage <3.0x: NCL will have to maintain two periods worth of coupon in escrow in an Interest Service Reserve Account, in order to cure the technical default.

From 30/07/17 onwards:
- Interest coverage falls below 3.0x but above 2.0x: NCL will have to maintain one periods worth of coupon in the Interest Service Reserve Account.
- Interest coverage falls below 2.0x but above 1.0x: NCL will have to maintain two periods worth of coupon in the Interest Service Reserve Account.
- Interest coverage falls below 1.0x: **the cure mechanism cannot be utilized and NCL would be considered to be in technical default**. This term is a deviation from the typical terms that we have seen from other recent offshore marine consent solicitations, and we consider it additional protection for bondholders.

The recent covenant amendments by offshore marine issuers have been focused on their earnings related covenants, such as interest coverage, due to volatility in EBITDA generation given the weak environment. Comparatively, pure balance sheet covenants, such as Consolidated Total Borrowings to Consolidated Tangible Net Worth, tend to be more stable (NCL did not seek to amend this covenant).

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[1] OCBC Asia Credit - Nam Cheong - Credit Update - 181115

In exchange for consenting to the proposals, bondholders would receive 50bps in early consent fees (if approval is provided by 18/01/16) or 25bps in normal consent fees (if approval is provided before the deadline of 25/01/16).

- **Challenging environment to persist**: As discussed during our last credit update on NCL, the environment remains challenging for shipbuilders such as NCL, given the slump in demand for newbuilds. Given NCL's build-to-stock ("BTS") model, NCL's inventory has been increasing, leading to a drain on cash as NCL has not been able to sell the vessels (in 2015, NCL only announced the sale contract for two vessels). During 3Q2015, we have also started to see receivables being stretched, though NCL offset this by delaying payments to suppliers. In aggregate, NCL generated negative MYR592.8mn in free cash flow during 9M2015, and funded the cash burn with increases in borrowings (hence the deterioration of net gearing from 0.42 as of end-2014 to 0.97 as of end-3Q2015). Looking forward, our key concern is NCL's ability to reduce the cash burn and stabilize its credit profile, and we have reached out to management for additional details.

- **2016 vessel pipeline**: The original delivery schedule was for 30 vessels to be delivered to NCL in 2016. Management has indicated that this number has been reduced significantly (deferred to 2017), and will share the revised figure in due time (they are currently negotiating to reduce the figure further). When queried if the 3rd party Chinese yards have been willing to cooperate in these deferments, NCL stated that they have been working with these yards for a long time, and that these yards have been accommodating. When asked, management also provided ~USD200mn as the notional value for vessels to be delivered from 3rd party yards during 2016. Management guided that ~30% of the vessel cost is typically paid upfront and through milestones to the 3rd party yards, with the balance due upon delivery. As such, the liquidity required for the balance of payments for the 2016 deliveries is ~MYR620mn. As for the original delivery schedule for 2017, management has not yet publicly stated any numbers, but indicated that the schedule was a lot more manageable.

- **Funding options**: With no bond maturities due till the SGD90mn bond due August 2017, NCL's main liquidity needs would be to finance the vessel construction and deliveries. Management has stated that they are confident of meeting their cash needs by relying on bank financing (which they stated they did through the 2009 down cycle). Though their revolving facilities are renewed annually, they believe that the revolvers will continue to be renewed. In addition, management stated that they still have MYR1bn worth of committed bank facilities (USD denominated, secured, cost of LIBOR + ~2%) that are currently undrawn, to meet their liquidity needs. In our view, it would seem that NCL still has some access to liquidity to meet their operating cash shortfalls, though leverage is likely to continue to trend higher. We believe that the consolidated borrowings to consolidated tangible net worth covenant of 150% will cap leverage on the upside.

- **Improvements to cash burn still pending**: Management indicated that NCL only aggressively sought to delay the 3rd party vessel deliveries from 1H2015 onwards. As such, the improvements from cash management will be more visible from 3Q2015 onwards. We have indeed seen some improvements, with free cash flow improving slightly from –MYR296.7 (2Q2015) to –MYR216.4mn (3Q2015). To us, cash burn management is crucial, as post NCL's November 2015 bond redemption, we previously estimated pro-forma end-3Q2015 cash balance to be just ~MYR280mn. This is an area that we will continue to monitor closely.

- **Order book status**: One area of risk would be order deferments by NCL's end customers (we have seen this impact other players in the offshore marine sector). Though NCL still has an outstanding order backlog of MYR1.4bn (as of end-3Q2015), any client order deferments could pressure NCL's revenue and stretch liquidity further. NCL has mentioned that they remain confident that their vessels will eventually be purchased given their long-term outlook (and given the long-term relationships through cycles that they have with their end clients in their core market of Malaysia), and that the current slump is driven by clients opting to delay new orders until the volatility in energy markets subside.

  Recommendation: In summation, we believe that NCL will continue to face a challenging 2016 given the pressure of funding the scheduled vessel deliveries for the year, as well as given the weak demand for newbuilds. We believe that though NCL still has some options to manage near-term liquidity, these would lead to further deterioration of NCL's credit profile. That said, with management guiding improvements in cash burn from 4Q2015 onwards, we would recommend investors to agree to the proposals made in the consent solicitation exercise. We will continue to maintain our **Negative** Issuer Profile on NCL.

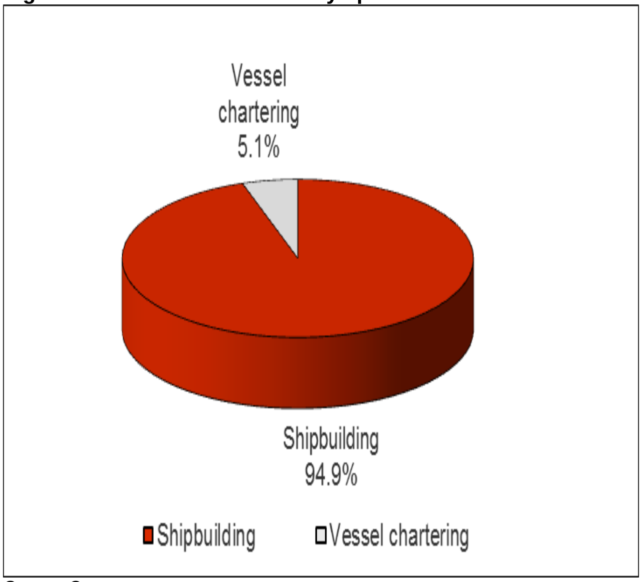
Nam Cheong Ltd

Table 1: Summary financials

Year ended 31st December	FY2013	FY2014	9M2015
Income statement (MYR' mn)			
Revenue	1,257.4	1,928.6	708.2
EBITDA	211.9	306.6	69.3
EBIT	198.9	289.0	53.4
Gross interest expense	33.6	53.5	39.4
Profit Before Tax	199.2	303.3	52.4
Net profit	205.6	301.8	50.0
Balance Sheet (MYR'mn)			
Cash and bank deposits	362.0	800.1	614.8
Total assets	2,179.2	3,252.4	4,055.7
Gross debt	851.2	1,309.3	1,941.3
Net debt	489.1	509.2	1,326.5
Shareholders' equity	938.6	1,219.3	1,371.1
Total capitalization	1,789.8	2,528.7	3,312.4
Net capitalization	1,427.8	1,728.6	2,697.6
Cash Flow (MYR'mn)			
Funds from operations (FFO)	218.7	319.5	65.8
CFO	-229.6	60.9	-591.3
Capex	44.0	6.1	1.5
Acquisitions	0.2	117.4	0.0
Disposals	7.3	148.3	0.1
Dividends	25.9	54.7	84.9
Free Cash Flow (FCF)	-273.6	54.8	-592.8
Adjusted FCF*	-292.4	31.0	-677.6
Key Ratios			
EBITDA margin (%)	16.9	15.9	9.8
Net margin (%)	16.4	15.6	7.1
Gross debt/EBITDA (x)	4.0	4.3	21.0
Net debt/EBITDA (x)	2.3	1.7	14.4
Gross debt/equity (x)	0.91	1.07	1.42
Net debt/equity (x)	0.52	0.42	0.97
Gross debt/total capitalization (%)	47.6	51.8	58.6
Net debt/net capitalization (%)	34.3	29.5	49.2
Cash/current borrowings (x)	1.50	1.44	0.73
EBITDA/gross interest (x)	6.3	5.7	1.8

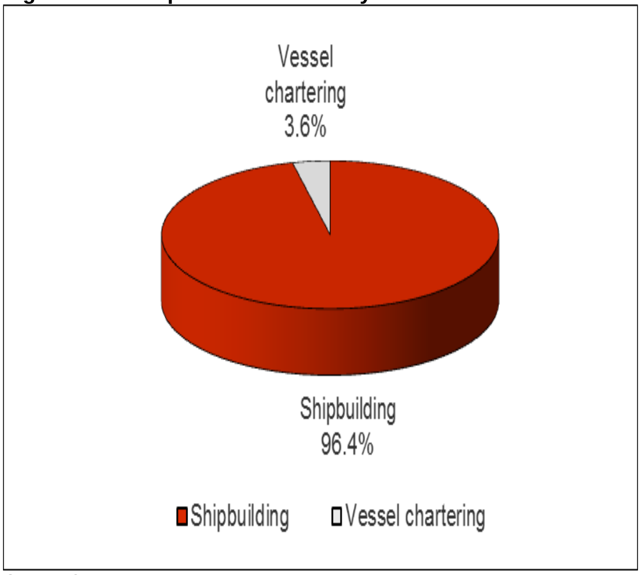
Source: Company, OCBC estimates
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

Figure 1: Revenue breakdown by operations – 9M2015



Source: Company

Figure 2: Gross profit breakdown by business line – 9M2015



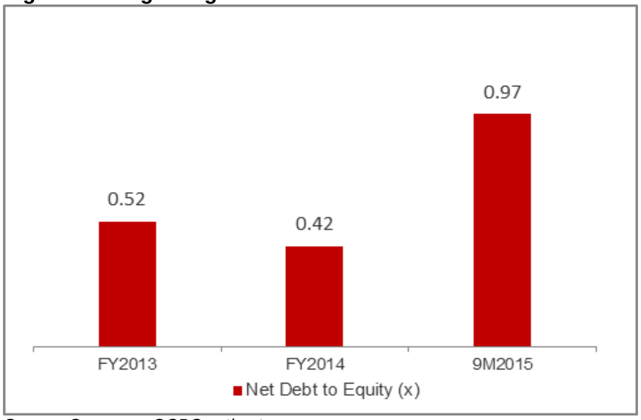
Source: Company

Figure 3: Debt maturity profile

Amounts in MYR mn	As at 30/09/2015	% of debt
Amount repayable		
One year or less, or on demand		
Secured	504.5	26%
Unsecured	339.8	18%
After one year		
Secured	209.5	11%
Unsecured	887.5	46%
Total	**1,941.3**	**100.0%**

Source: Company

Figure 4: Net gearing



Source: Company, OCBC estimates

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