Asia Credit Research

# Swissco Holdings Limited: Credit Update

**Wednesday, 05 October 2016**

## Tread Cautiously

- 1H2016 results show losses from low utilization and poor charter rates. Of the 9 rigs that SWCH has exposure to, 4 are currently off charter.
- In aggregate, SWCH has shown signs of liquidity pressure, though leverage levels looked manageable. No details regarding issuer intent just yet, but recent restructurings in the sector offer clues.
- For now we will reiterate our **Negative Issuer Profile on SWCH and withdraw our bond level recommendation on the SWCHSP'18s until the details regarding any potential restructuring are revealed.**

- **What's looming**: Swissco Holdings ("SWCH") has announced on 04/10/16 that it would be appointing Ernst & Young as independent financial advisor to SWCH to assist in the refinancing and restructuring of the SGD100mn in bonds. SWCH has indicated that given the looming interest payment on the bonds due on 16/10/16, the issuer has engaged its bank lenders as well as holders of the redeemable exchangeable preference shares ("preference shareholders") to restructure its balance sheet. SWCH plans to hold an informal bondholder meeting on 10/10/16 to update noteholders on the situation. In this report, we will review the recent developments in SWCH as well as consider the recent restructurings in the offshore marine space to get some sense regarding what might be proposed come the informal meeting on 10/10/16.

### Recent Performance

- **2Q2016 results pressured by poor utilization**: As mentioned previously[1], quarterly revenue plunged 72.8% y/y to USD5.0mn. This was due to both of SWCH's wholly-owned drilling rigs falling off charter, which resulted in the drilling segment reporting no revenue (these two rigs fell off charter in 2Q2015 and 4Q2015 and have been unable to find contracts). It is also worth noting that two of SWCH's 50% JV drilling rigs are off-charter. On a q/q basis however, revenue was up 4.0%. The slight increase was driven by SWCH's OSV chartering business (+4.2% q/q to USD5.0mn). The OSV segment however remains weak on absolute terms due to poor utilization and low charter rates. In aggregate, due to the oversupply of both drilling assets as well as offshore support vessels in the market, we believe that both SWCH's segments would be pressured for some time. As the two wholly-owned rigs are not operating, this has resulted in SWCH generating an operating loss of USD9.0mn, comparable to the previous quarter's operating loss of USD9.7mn. Note that SWCH faces high depreciation costs (non-cash) of ~USD6mn per quarter due to its rigs and OSV fleet.

- **Necessary expenses to deploy assets**: SWCH also spent USD2.6mn in stacking and mobilization costs for its rigs (management last mentioned redeploying the rigs ultimately to the Middle East) in order to find charters for

**Treasury Advisory**
**Corporate FX & Structured Products**
Tel: 6349-1888 / 1881
**Interest Rate Derivatives**
Tel: 6349-1899
**Investments & Structured Products**
Tel: 6349-1886

**GT Institutional Sales**
Tel: 6349-1810

**OCBC Credit Research**
**Nick Wong Liang Mian, CFA**
+65 6530-7348
NickWong@ocbc.com

[1] OCBC Asian Credit Daily - 15 August 2016

them. As such, we expect these expenses to be necessary for SWCH to seek new contracts for its rigs as well as to be non-recurring. One of the rigs are currently warm stacked (kept in a state that allows for quick deployment upon contract) in the Gulf of Mexico, while the other three are warm stacked in West Africa. Given the challenges that Pemex (the original client for these rigs) was facing, redeployment was one of the options to find work. The other option would have been to put the rigs into cold stack (puts the rigs into preservation, which is more cost efficient, but there would be a relatively longer time lag before a rig in cold stack can be redeployed).

- **JV contributions a crutch for now**: As a reminder, aside from its OSV fleet, SWCH has exposure to 7 drilling rigs and 2 accommodation rigs. With the exception of two wholly-owned drilling rigs, the rest of the 7 rigs are all held via JVs. The share of results from these JV assets helped support earnings, contributing USD9.3mn (1Q2016: USD9.7mn). This helped trim net loss to USD2.1mn (1Q2016: USD1.9mn). The accommodation rigs are less vulnerable compared to the remaining 3 drilling rigs (which will see their contracts complete in roughly two years).

- **Liquidity is tight, though gearing levels manageable**: SWCH generated negative USD3.5mn in operating cash flow for the quarter (including finance costs), largely driven by its interest service. After factoring USD2.4mn in capex, free cash flow was negative USD5.9mn. SWCH also paid down USD9.7mn in borrowings. This was funded by USD1.8mn in asset disposals (likely vessels) as well as by drawing down on its cash balance. As a result, SWCH ended the quarter with just USD9.6mn in cash balances. With the additional borrowings as well as net loss, net gearing inched higher q/q to 78% (1Q2016: 76%). As of end-2Q2016, SWCH had USD72.5mn in short-term borrowings due (~80% is secured vessel / rig financing), compared to USD9.6mn in cash balances. Management had indicated in their 2Q2016 filings that they were expecting to rollover USD42.6mn in short-term borrowings and were in active discussions for the balance. In aggregate, we note that net gearing for SWCH at 78% is currently one of the lowest amongst our offshore marine coverage. We estimated interest coverage for the quarter (based on covenant calculations) to be ~2.54x, just above the 2.5x required by the covenant.

**Deciphering Swissco's Intentions**

The announcement by SWCH that it is considering the restructuring of its bonds at this point in time comes as a surprise to us. Debt restructuring is usually the last resort taken only when other avenues have been considered. Though we considered the possibility of SWCH seeking for waivers to its financial covenants given the limited covenant headroom available for its interest coverage covenant (several of the smaller offshore marine issuers under our coverage have already undergone consent solicitations for covenant relief), the announcement seemed to indicate a more extensive restructuring of the bonds. Though the tentative terms will likely be disclosed during the informal bondholders meeting on 10/10/16, the following should be kept in mind when considering SWCH's management's case for relief.

1. **No balloon maturity pressure**: Unlike other issuers that have been in the news seeking to restructure their bonds (AusGroup, Marco Polo Marine, Perisai), SWCH's bonds will only mature in April 2018. Instead, with SWCH highlighting the October coupon payment as a factor, it would seem that SWCH's liquidity situation could be more dire than previously expected and possible difficulty in rolling over short term borrowings. That said, the coupon due in October is SGD2.85mn. Comparatively, during 1H2016 alone, SWCH has provided USD9.6mn in loans to its JVs. In addition, SWCH just made USD2.0mn in asset divestments during 1H2016 despite reporting USD176.4mn in vessels / barges at

the end of 2015.

2. **SWCH remained profitable in 2015**: SWCH reported USD31.2mn in net profit for 2015. Though SWCH swung into a loss from 4Q2015 onwards, the bulk of 4Q2015 losses were driven by asset impairments. 1H2016 performance was more reflective of the stress that the company was undergoing.

3. **SWCH still paid dividends**: SWCH paid out USD10mn in dividends during 2015 (declared as part of FY2014 results) and paid out USD0.5mn in dividends during 1H2016 (declared as part of FY2015 results).

4. **SWCH was attempting M&A**: SWCH announced in April 2016 that it considered acquiring VM Marine International, though subsequently on 15/08/16 SWCH announced that the deal failed to go through.

5. **SWCH still had balance sheet room**: Though SWCH's liquidity faces some pressure, its net gearing stood at 78% as of end-June 2016. In aggregate, SWCH reported USD221.6mn in gross borrowings, versus USD519.8mn in total assets. Furthermore, SWCH has minimal intangible assets on its balance sheet. Though there could possibly be more impairments taken on its rig fleet at year end given the challenging environment (and having taken one round of impairments at the end of 2015), SWCH looked to have some buffer (although at the discretion of its lenders).

6. **Auditors signed off SWCH's accounts**: KPMG, SWCH's external auditor, gave an unqualified opinion of SWCH's 2015 audited financial statements, and signed off on the statements on 31/03/16. In addition, SWCH's board of directors affirmed as part of its annual report that "there are reasonable grounds to believe that the Company will be able to pay its debts as and when they fall due".

**Some Possible Outcomes**

Since Swiber's bankruptcy at the end of July, several issuers with short-term bond maturities have restructured their bonds out-of-court to avoid balloon default. It is worthwhile to consider the spectrum of outcomes to anticipate what SWCH could potentially seek from bond holders:

A) **Waiver of financial covenants**: As mentioned, SWCH's interest coverage covenant was tight as of end-2Q2016. SWCH could potentially be seeking a waiver, to include a cure mechanism, or to outright remove the covenant.

B) **Amend and extend**: In the case of Otto Marine and Ausgroup, bond maturities were extended in order for certain events to occur which would facilitate the redemption of the bonds. As SWCH's bond maturity is not in the near future, steps to extend the bond could be premature and should only be considered if there are good grounds to do so rather than an arbitrary reason at the expense of bondholders. Key to an equitable extension to the maturity of the bonds are concrete plans as to how management intends to utilize the time. For Otto Marine, it was to provide time to allow Otto Marine to delist. For AusGroup, it was to provide more time for management to dispose of its port assets (with proceeds pledged to pay down bondholders).

C) **Provision of collateral**: In the case of Ausgroup and Marco Polo, the issuers provided collateral as an incentive for bondholders to approve the restructuring. This provides bondholders with some comfort as to where funds to redeem the bonds would come from. Whether the collateral is adequate to cover the entire bond issue is a separate factor to consider.

D) **Haircuts to coupon or principal**: In the on-going Rickmers Maritime ("RMT") restructuring, RMT had initially sought to haircut the bondholders' principal down to 28% of the original notional amount. In highly distressed situations, such haircuts on bondholders could be a condition for bank lenders (who are typically secured and senior in priority of claims to bondholders) to continue lending to the issuer. In the RMT situation, the restructuring of the bonds was a condition for bank lenders to refinance bank lending. Reduction in coupon rates could also be floated in order for the issuer to preserve liquidity.

E) **Equitization (exchanging debt for equity)**: As part of the RMT restructuring, bondholders were offered shareholding in the company in exchange for principal forgiveness. An advantage of this is that it provides some upside to bondholders, as well as gives bondholders an avenue to exit by selling the shares if they choose to. The disadvantage is that if the company continues to be distressed, the shares would continue to trade lower and potentially be wiped out in further restructurings.

F) **Threat of liquidation or court restructuring**: Issuers could potentially voice out their inability to continue as a going concern unless their debt is restructured. This is where bondholders should press for the most details.

**Pivotal Factors to Consider**

When reviewing the terms and conditions provided by SWCH, or any other companies seeking restructuring in general, bondholders should bear the following in mind.

A) **Going concern trumps liquidation:** Companies are typically worth more alive than dead. This is the reason why in most restructuring regimes, the intent is to rehabilitate the company (Chapter 11 bankruptcy in the US regime) rather than liquidation (Chapter 7).

B) **Judicial management can be costly:** Fees to the judicial manager are senior in claim to most creditors. The longer the company spends restructuring, the lower the likely recoveries for creditors as resources would continue to be consumed until the company stabilizes.

C) **Priority of claims:** Bondholders are senior in the priority of claims over shareholders. If bondholders' principal has been impaired, shareholders should be greatly diluted (in the event of fresh equity being injected) or wiped out. In addition, bondholders could receive equity (be equitized) as part of their recovery. This provides alignment between bondholders and shareholders in that only in the direst situation would shareholders seek to impair bondholders as it would be detrimental to their own position.

D) **Terms are negotiable:** As a consent solicitation is essentially an out-of-court restructuring, the terms are negotiable. The initial RMT restructuring was rejected by bondholders as it was perceived to be inequitable as bondholders had huge haircuts while shareholders only faced a maximum dilution of 20%. The revised proposal by RMT was improved significantly, with bondholders offered the majority equity stake in RMT, as well as a lower haircut on the bonds. Even then, some RMT bondholders believed the revised proposal to be inadequate and have attempted to accelerate the bond redemption.

**More Transparency is Key**

In our view, management disclosure is paramount. There are some elements that should be questioned further in order for bondholders to make their decisions in the restructuring:

A) **Contingent Liabilities**: Given the many joint ventures and associates that SWCH utilizes to hold the bulk of its rigs, and that the financing of these non-wholly owned rigs are off-balance sheet, there has to be better disclosure on SWCH's contingent liabilities with regards to these JVs / associates. In the most recent annual report, it was stated that "There were no significant contingent liabilities as at 31 December 2014 and 2015". Disclosed corporate guarantees for JVs / associates totalled USD94.8mn as of the 2015 annual report. This compares against the USD211.6mn in gross borrowings that SWCH currently has. When considering the contingent liabilities at the JV / associate level, the assets in these JV / associates have to be considered as well.

B) **Redeemable exchangeable preference shareholders**: These are preference shares issued by the JV / associates which SWCH has and that hold some of its rigs (as part of the original financing of the acquisition of these rigs). Some of the terms disclosed regarding these preference shares include a "Maturity Date" in which SWCH has the right, but not the obligation to redeem these shares. More needs to be disclosed regarding the claims of these preference shareholders (at the JV / associate levels).

C) **Shareholder Loans to JV / associates**: SWCH had been providing funding to its JV / associates. More details need to be providing regarding these as they have been sizable (USD9.6mn cash outflow via loans to JV in 1H2016).

D) **Management / impairments of their fleet**: More details have to be provided regarding the rigs that are currently off-lease. Currently, all four rigs which SWCH acquired in 2014 are off charter. Some have been off charter since 2Q2015. More details have to be provided.

**Recommendation**: Given the challenging environment for offshore marine, and given the oversupply in drilling assets, we have downgraded SWCH's Issuer Profile to Negative from Neutral at the beginning of this year[2] as well as reiterated the Negative Issuer Profile based on 2Q2016 results[3]. We had previously held the SWCHSP'18 at Neutral on the basis of valuation[4]. Given that the terms of the potential restructuring have not yet been disclosed, we will be unable to provide a bond-level recommendation until we have the chance to review the terms. **As such, we are reiterating our Negative Issuer Profile on SWCH and withdrawing our recommendation on the SWCHSP'18s for the time being**.

[2] OCBC Singapore Credit Outlook 2016

[3] OCBC Asian Credit Daily - 15 August 2016

[4] OCBC Asia Credit Monthly (Aug 2016) - The bulk of our offshore marine coverage are currently rated with Negative issuer profiles, reflecting the stressed fundamentals given the challenging environment. With regards to their specific bond recommendations, these have been largely held at Neutral on a valuation basis, as the yields on the bonds already imply significant distress. To exit these positions currently would likely result in material losses in invested capital, exacerbated by the poor secondary liquidity in these bonds.

# Swissco Holdings Ltd

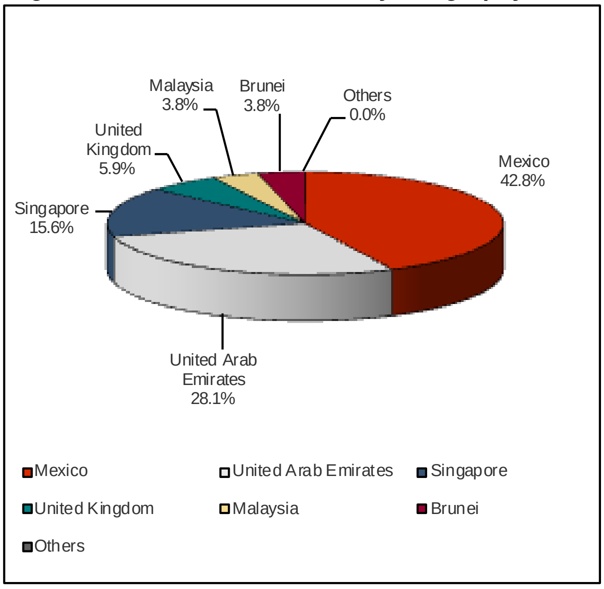
**Table 1: Summary Financials**

| Year End 31st Dec | FY2014 | FY2015 | 1H2016 |
|---|---|---|---|
| **Income Statement (USD'mn)** | | | |
| Revenue | 65.5 | 69.6 | 9.8 |
| EBITDA | 21.3 | 60.0 | 13.7 |
| EBIT | 11.5 | 34.4 | 1.5 |
| Gross interest expense | 4.7 | 11.6 | 5.6 |
| Profit Before Tax | 15.5 | 32.0 | -3.7 |
| Net profit | 15.9 | 31.2 | -4.1 |
| **Balance Sheet (USD'mn)** | | | |
| Cash and bank deposits | 38.6 | 37.6 | 9.6 |
| Total assets | 548.3 | 531.1 | 519.8 |
| Gross debt | 250.8 | 232.8 | 221.6 |
| Net debt | 212.1 | 195.3 | 212.0 |
| Shareholders' equity | 254.3 | 275.7 | 271.7 |
| Total capitalization | 505.1 | 508.5 | 493.3 |
| Net capitalization | 466.4 | 471.0 | 483.7 |
| **Cash Flow (USD'mn)** | | | |
| Funds from operations (FFO) | 25.7 | 56.7 | 8.1 |
| CFO | 47.2 | 8.3 | -5.0 |
| Capex | 168.7 | 34.8 | 3.8 |
| Acquisitions | -9.6 | 0.0 | 0.0 |
| Disposals | 4.8 | 30.8 | 2.4 |
| Dividend | 0.0 | 10.0 | 0.5 |
| Free Cash Flow (FCF) | -121.4 | -26.4 | -8.9 |
| FCF adjusted | -107.0 | -5.6 | -7.0 |
| **Key Ratios** | | | |
| EBITDA margin (%) | 32.5 | 86.1 | 139.5 |
| Net margin (%) | 24.3 | 44.8 | -41.4 |
| Gross debt to EBITDA (x) | 11.8 | 3.9 | 8.1 |
| Net debt to EBITDA (x) | 10.0 | 3.3 | 7.8 |
| Gross Debt to Equity (x) | 0.99 | 0.84 | 0.82 |
| Net Debt to Equity (x) | 0.83 | 0.71 | 0.78 |
| Gross debt/total capitalisation (%) | 49.6 | 45.8 | 44.9 |
| Net debt/net capitalisation (%) | 45.5 | 41.5 | 43.8 |
| Cash/current borrowings (x) | 0.5 | 0.5 | 0.1 |
| EBITDA/Total Interest (x) | 4.5 | 5.2 | 2.5 |

*Source: Company, OCBC estimates*

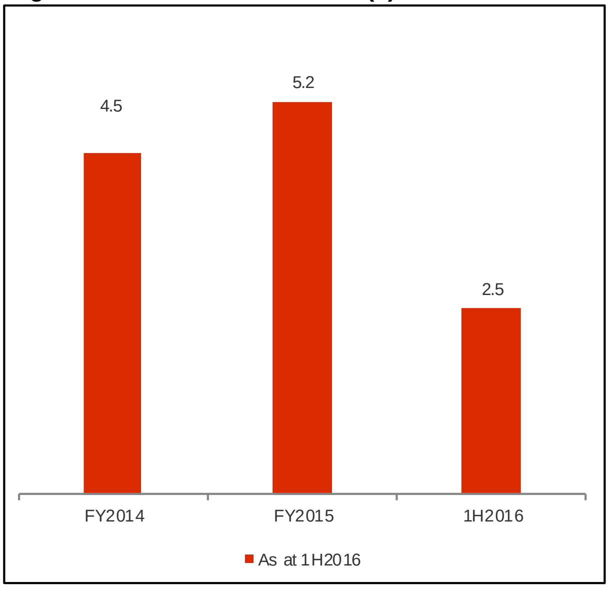
** FCF Adjusted = FCF - Acquisitions - Dividends + Disposals*

**Figure 1: Revenue breakdown by Geography - FY2015**




*Source: Company*

**Figure 2: EBITDA/Total Interest (x)**



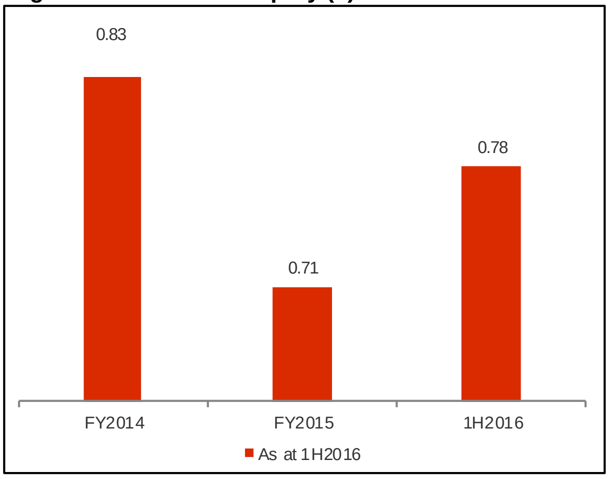

*Source: Company*

**Figure 3: Debt Maturity Profile**

| Amounts in (USD'mn) | As at 30/06/2016 | % of debt |
|---|---|---|
| **Amount repayable in one year or less, or on demand** | | |
| Secured | 57.6 | 26.0% |
| Unsecured | 15.0 | 6.8% |
| | **72.5** | **32.7%** |
| **Amount repayable after a year** | | |
| Secured | 75.8 | 34.2% |
| Unsecured | 73.3 | 33.1% |
| | **149.1** | **67.3%** |
| **Total** | **221.6** | **100.0%** |

*Source: Company*

**Figure 4: Net Debt to Equity (x)**




*Source: Company, OCBC estimates*