Asia Credit Research

Nam Cheong Limited: Credit Update

Tuesday, 09 May 2017

Something's Brewing

- NCL had announced that due to the challenging environment, it had taken steps to review its options to restructure its business, operations and balance sheet to preserve value for stakeholders of the company. Aside from operational decisions to manage cost, discussions with creditors to refinance / restructure existing borrowings have commenced.

- Recent performance continues to be weak, with NCL hit by order cancellations as well as client requests for delivery delays. This has pressured cash flow generation. The balance sheet continues to expand due to increasing inventory from BTS vessels, and these were funded by additional borrowings / drawing down on cash balance.

- Scenario analysis was conducted to consider NCL's options, based on restructurings taken by industry peers. Maintaining the status quo looks challenging, particularly with a near-term bond maturity (28/08/17). 1Q2017 results, to be announced in the near future, could be the launch pad to initiate discussions with creditors such as bondholders.

- We will reaffirm our **Negative Issuer Profile on NCL**, given the difficult environment which is likely to pressure revenue and cash flows in the near future, preventing improvements to credit profile. Should a bond restructuring take place, uncertainty over the path of the restructuring coupled with the broad spectrum of outcomes make it difficult for us to provide bond-level recommendations. As such, **we are withdrawing our bond recommendations on the NCLSP'17s, NCLSP'18s and NCLSP'19s**.

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A) Background

NCL had recently announced[1] that due to the continued weakness in the global oil and gas industry, it had taken steps to review its options to restructure its business, operations and balance sheet to preserve value for stakeholders of the company. Specifically, measures include: A) discussions with principal lenders to address significant debt maturities, which may include refinancing / restructuring of existing loans; B) review of operations as well as discussions on possible transactions with the aim of containing operating costs; and C) stepping up efforts to improve its financial position whilst continuing its cost rationalization measures.

The above announcement was only the last of a series of developments that have occurred since the beginning of 2017. NCL had seen its CFO resign in January 2017, announced that its auditor included an emphasis of matter with respect to material uncertainty relating to NCL's going concern status and recent changes to shareholder's

[1] OCBC Asian Credit Daily – 24 Apr 2017

equity. Given the looming 1Q2017 results expected sometime next week, it may be insightful to consider NCL's recent performance, issues arisen and steps taken as well as potential alternatives that NCL may consider when factoring what NCL's peers in the offshore marine space have done.

B) Recent Performance

Perdana bailing pressured revenue: For full-year 2016 results, NCL reported MYR170.4mn in revenue, plunging 82.1% y/y. This was largely due to Perdana Petroleum Berhad's ("Perdana") cancellation of its two Accommodation Work Barge ("AWB") orders with NCL. As previously mentioned[2], the second AWB was completed, with NCL sending the first Notice of Readiness on 26/10/16. However, Perdana sent a notice of cancellation on 01/12/16, which NCL described to be a breach of contract and is currently pursuing damages from Perdana. As a reminder, NCL reported negative MYR93.1mn in revenue during 1Q2016 due to Perdana's order cancellation of the first AWB on order. In aggregate, the two AWB were ordered in June 2014 for a contract value of USD84mn. Client requests for delivery delays also led to slower revenue recognition. Though NCL was able to maintain its shipbuilding gross margins at 17% for the year (the same level as 2015), the ship chartering segment generated a gross loss of MYR16.9mn, reflecting the tough environment for OSV chartering. In aggregate, NCL generated a net loss of MYR42.8mn for the year (with MYR59.8mn in inventory impairments being a large drag) versus a net profit of MYR27.9mn for 2015.

Inventory of BTS ships remains a cash burden: As NCL's original business model was to engage partner third-party yards to build ships before clients are found (build-to-stock, or "BTS"), the slump in demand for newbuilds the last few years meant NCL funding and taking these BTS vessels onto their balance sheet, taxing working capital and being a drag on operating cash flow. During 4Q2016, NCL generated MYR10.3mn in operating cash outflow. This was an improvement over the MYR62.2mn in operating cash out-flow seen in 2Q2016 as well as the MYR125.4mn out flow seen in 1Q2016. Though for 4Q2016, inventory remains a drag on cash (MYR303.6mn impact, but likely included the transfer of the cancelled AWB from customer receivables to inventory), NCL controlled its cash burn by chasing its receivables and stretching its payables. For the full year, NCL saw an operating cash-outflow of MYR291.0mn (of which MYR305.2mn was driven by an increase in inventory). NCL had been able to work with its partner yards in delaying the delivery of BTS vessels (hence mitigating cash burn) but it is uncertain how much longer these yards are willing to delay delivery.

Gearing stabilized, liquidity weak: Net gearing has increased to 111% y/y (end-2015: 95%), though it had been stable since 3Q2016. To fund its cash needs, NCL had been drawing down on its cash balance (fell MYR204.6mn to MYR301.5mn y/y) as well as tapping on its revolving credit facilities. EBITDA for 2016 was negative due to the revenue reversals from the Perdana cancellations. The biggest challenge for NCL remains its short-term borrowings, which total MYR948.7mn (as of end-2016, including the SGD90mn in bonds due 28/08/17). NCL's short-term debt burden was one of the issues highlighted by BDO LLP ("BDO"), NCL's auditor, when BDO included an emphasis of matter (as part of its audit of NCL's financial statements) with regards to the material uncertainty relating to NCL as a going concern[3].

Outlook remains challenging: Though steps have been taken to control cash burn on a quarterly basis, it would be difficult for NCL to generate enough cash flow to service its short-term borrowings without being more aggressive in monetizing its huge inventory (MYR2.4bn currently). Future performance would likely remain lacklustre as the OSV market continues to be challenged by oversupply and still weak upstream activity impacting demand (NCL last announced order wins in March 2015). As such, it would be difficult for NCL to win new orders for its yards / monetize the BTS vessels in

[2] OCBC Asian Credit Daily – 7 Dec 2016
[3] OCBC Asian Credit Daily – 20 Mar 2017

inventory. It is worth noting that NCL stopped reporting its order book during the most recent quarterly filing. NCL last reported its order book at MYR1.05bn during 3Q2016, but this likely included the AWB which Perdana subsequently cancelled. For 1Q2017 results, more of the same is expected, with revenue generation weak (though higher q/q on the lack of order cancellation) and cash flow generation anaemic.

C) Current Developments

i) **Capital reorganization exercise**: On 23/03/17, NCL initiated a capital reorganization exercise, to reduce the par value of NCL's shares from HKD0.50 per share to HKD0.10 per share, while keeping issued shares at 2,103,144,482. The credit arising from the capital reduction exercise, HKD841.3mn, would be credited to retained earnings. Management rationale for the exercise was that as NCL was incorporated under Bermuda law, NCL would not be able to issue shares at below par value. By reducing NCL's par value per share, it would provide NCL with the flexibility to raise funding via issuance of new shares in the future, or to facilitate a corporate action which may require the issuance of new shares. The capital reorganization motion was put to vote to shareholders and was successfully passed on 24/04/17.

Considerations and Implications: It should be noted that since then, NCL's share price has continued to fall, and has traded at an average of SGD0.021 (~HKD0.117) per share over the last month (hitting a low of SGD0.016 during the period). As such, NCL's current share price may again prove to be a hindrance to the issuance of new shares. The reorganization could allow NCL to issue new shares and raise capital to buttress the balance sheet. Another possible scenario though, would be NCL issuing new shares to bondholders in exchange for partial / complete redemption of NCL's existing bonds, as part of NCL's efforts to restructure its borrowings. This would be similar to Rickmers Maritime Trust's revised restructuring proposal made in September 2016[4].

ii) **Notice of group restructuring**: On 23/04/17, NCL made an announcement regarding group restructuring. As per the filing, NCL disclosed some on-going measures that are currently being taken: A) discussions with principal lenders to address significant debt maturities, which may include refinancing / restructuring of existing loans; B) review of operations as well as discussions on possible transactions with the aim of containing operating costs; and C) stepping up efforts to improve its financial position whilst continuing its cost rationalization measures. It should be noted that subsequent to NCL's earlier announcement on 17/03/17[5] (pertaining to BDO's statements over NCL's going concern status), NCL has received letters of demand as well as reservation of rights letters from its counterparties, including its financial lenders. NCL had highlighted that no definite agreements with regards to the restructuring has been entered into. NCL had also indicated that in the event the restructuring is not favourably completed in a timely manner, NCL will be faced with a going concern issue.

Considerations and Implications: Things are starting to accelerate, with some of NCL's creditors taking action to preserve their interests. NCL's SGD90mn in bonds due on 28/08/17 is likely a hard deadline that NCL would have to manage. As a reference, ASL Marine Holdings first publically disclosed a potential need to restructure its existing bonds on 11/11/16[6], more than four months before the maturity of ASL Marine's bond (originally 28/03/17), in order to access fresh capital provided by its bank lenders.

4 OCBC Asian Credit Daily – 23 Sep 2016

5 OCBC Asian Credit Daily - 20 Mar 2017

6 OCBC Asian Credit Daily - 12 Nov 2016

With the above current developments in mind, it is possible that NCL would initiate discussions with bondholders regarding NCL's debt restructuring after 1Q2017 results are published (expected mid-May 2017). As such, in the next section, possible scenarios based on the various restructurings seen in the SGD corporate bond space will be considered.

D) Scenario Analysis

Scenario #1: Status Quo

- The focus of NCL's restructuring to be on bank borrowings. Of the MYR948.7mn in current borrowings, ~70% are secured bank facilities (term loans and revolving credit facilities). NCL to potentially raise additional equity to provide comfort to creditors to roll over bank debt.

- The NCLSP'17 to be redeem via tapping on unutilized bank facilities and cash balance. More aggressive monetization of inventory to pay down borrowings.

Considerations and Implications: The crux of the above scenario is providing comfort to bank lenders, potentially via the infusion of more equity. Based on NCL's most recent AGM though, NCL's board is currently only authorized to raise up to 50% of issued shares outstanding, or roughly 1.05bn new shares, which would bring in just ~SGD18mn (at today's prices of SGD0.017 per share), or ~MYR55mn. This amount may be too small versus NCL's current net debt position of MYR1.52bn. As such, to raise more equity, an EGM may need to be called. In addition, the above scenario does not provide much leeway to bring in more working capital, which may be required given NCL's delivery commitments from its partner yards. With the environment still weak, NCL would likely continue to face difficulty monetizing its inventory of vessels. Finally, the above does not address the other looming bond maturities, with the SGD75mn NCLSP'18s due on 23/07/18 and the SGD200mn NCLSP'19s due on 26/08/19.

Scenario #2: Amend and Extend

- The focus would be to extend NCL's existing bond curve, to provide time for the market to recover and for NCL to offload its vessels (without having to do distressed sales). Sweeteners, such as higher coupon, or equity upside (warrants) could be given to incentivize bondholders to agree. Collateral could also be given, and or commitments to utilize funds received to pay down debt.

- This could be a requisite by bank lenders as a condition to keep rolling over NCL's short-term borrowings (such as its revolving facilities), or to provide additional capital. Additional equity could be raised to give creditors comfort (and to provide shareholder alignment).

Considerations and Implications: A number of NCL's offshore marine peers had taken this route when facing maturity pressure. Issuers that completed their bond restructuring include AusGroup Ltd, Marco Polo Marine Ltd and ASL Marine Holdings. All three companies provided higher coupon as well as some form of security in exchange for their bond maturity extension. The latter is important as it gives bondholders some solace that there is collateral to support recoveries should the issuer fail in its turnaround. It should be noted that extending the maturity of the bonds is no panacea, and that the challenging environment could still hinder the performance of these issuers. Recently, Marco Polo Marine Ltd had indicated that it will not be able to make coupon payment on its restructured bonds[7]. In general, if NCL ultimately intends to amend and extend, it can be expected that NCL would simultaneously extend the

[7] OCBC Asian Credit Daily - 19 Apr 2017

maturities of all its existing bonds. In our view, what's important is that the issuer communicates its plans to generate future cash flow, in exchange for forbearance from bondholders. To be clear, attempts by NCL to defer or reschedule its indebtedness constitutes as an Event of Default under clause 9(f) under the bond MTN information memorandum (dated 30/06/15).

Scenario #3: Equitization

- NCL may deem its MYR1.82bn in gross debt unsustainable relative to its near-term ability to generate cash flows. Currently, of the MYR1.82bn in gross borrowings, ~60% are NCL's three SGD bonds. As such, NCL may seek to do an out-of-court debt restructuring, redeeming part of NCL's bonds in exchange for equity ownership in NCL.

- The intent of this path is to reduce NCL's leverage by swapping debt for equity, as well as save on interest expenses. The lower leverage would also provide confidence to bank lenders (who usually rank senior as they are secured) to continue to provide support to NCL. NCL's bondholders, though they will be structurally subordinated as equity holders, could potentially benefit from upside should NCL's stock recovers in the future. Positions in equity could also be more liquid relative to the existing NCL curve.

Considerations and Implications: There are many hurdles to the above scenario. The only issuer to attempt something similar in the SGD corporate bond space would be Rickmers Maritime Trust ("RMT"), with RMT's revised proposal to bondholders being 40% of original notional in extended maturity, lower coupon restructured bond, and the balance of the original notional redeemed in kind with newly issued equity (with bondholders holding ~60% of the diluted shareholdings)[8]. Ultimately, RMT's bond restructuring failed to go through.[9] We would consider the path of equitization to be detrimental to bondholders and should only be taken if there are no other alternatives (it falls on management to convince bondholders as such). There are many areas that could potentially be contentious, such as equity valuation (NCL currently has a market cap of just ~SGD36mn versus the SGD365mn in bonds outstanding) and the haircuts that bondholders have to endure. As per the previous scenario, this scenario would also constitute as an event of default.

Scenario #4: Court / System Driven Restructuring

- Should all out-of-court options fail, NCL could seek court protection by filing for judicial management or court-sanctioned schemes of arrangements in Singapore, or may even tap on foreign resolution schemes such as Malaysia's Corporate Debt Restructuring Committee (which was the route taken by Perisai Petroleum Teknologi) given that NCL's material subsidiary Nam Cheong Dockyard Sdn Bhd is incorporated in Malaysia.

- This path would offer to NCL a moratorium on its existing debt, which could provide the issuer with some time to revert with a restructuring plan should coordination with stakeholders fail and various creditors initiate unilateral action on NCL. Recent changes to the Companies Act in Singapore has facilitated the provision of super priority rescue financing[10], which would allow NCL access to fresh working capital. Such super priority rescue financing are a double edge sword, as on one hand such financing could help the distressed company survive as a going concern. On the other hand, such financing would

[8] OCBC Asian Credit Daily - 23 Sep 2016
[9] OCBC Asian Credit Daily - 13 Apr 2017
[10] OCBC Asia Credit - Changes to Singapore Restructuring (14 Mar 2017)

subordinate unsecured creditors (such as bondholders) and would impact recoveries in the event that the distressed company fails to turnaround.

Considerations and Implications: The potential outcomes for court / system driven restructuring would likely cover a broad spectrum. Currently, the offshore marine issuers in the SGD corporate bond space going through such restructuring (Swiber Holdings, Swissco Holdings, Ezra Holdings etc) have not completed their restructuring process, and as such the final recoveries for such peers are uncertain. Should judicial management be the path taken, it could take some time for the judicial manager to understand the company and revert with a restructuring plan. Thus far, what we have seen for issuers in judicial management would be the controlled liquidation of assets, with the judicial manager seeking to find buyers for either whole business segments, or individual assets such as vessels.

Scenario #5: Liquidation

As mentioned earlier, some of NCL's creditors have started to send in letters of demand. Should NCL be unable to satisfy demand from its creditors, creditors may proceed with a winding up petition, on the basis that NCL was unable to pay its debts. Should NCL be wound up, a liquidator would be appointed to close down the business, sell off assets and pay off creditors. In this scenario, NCL would be a gone concern. At the end of the process, NCL would be dissolved and cease to exist.

Considerations and Implications: Companies are usually worth more as a going concern rather than a gone concern. Existing customer relationships, contracts, employee / institutional knowledge etc all add to value, which would otherwise be rendered moot in a gone concern situation. Furthermore, as NCL's operating entities are foreign domiciled, it could add to complexity. Ultimately, business model complexity could also impact recovery values.

E) Conclusion

In summary, NCL continues to face a challenging environment, with the weak demand for newbuild OSVs hindering its ability to win new orders, as well as to offload the BTS vessels in its inventory. Existing clients have also requested delays to deliveries, resulting in pressure on NCL's cash conversion cycle. As a result, it has been challenging for NCL to monetize its working capital, with NCL relying on borrowings to meet its cash needs (such as committed capital spending such as vessel deliveries from partner yards). With its SGD90mn in bonds due soon on 28/08/17, and NCL announcing that it is reviewing options for group restructuring, the 1Q2017 results (to be announced later this week) could be the catalyst allowing NCL to initiate discussions with various stakeholders. We have described and considered 5 scenarios which could potentially pan out, as well as provided our views on each scenario. It would seem that sustaining the status quo would be difficult, and hence there could be a possibility of NCL's bonds facing some degree of restructuring. With various possible restructuring paths leading to a broad range of outcomes, as well as the binary nature of recoveries, it would be difficult for us to provide a bond recommendation across NCL's curve. As such, we will be withdrawing our bond recommendation on the NCLSP'17s, NCLSP'18s and NCLSP'19s. We will continue to hold our Negative Issuer Profile on NCL and will continue to monitor NCL's performance closely.

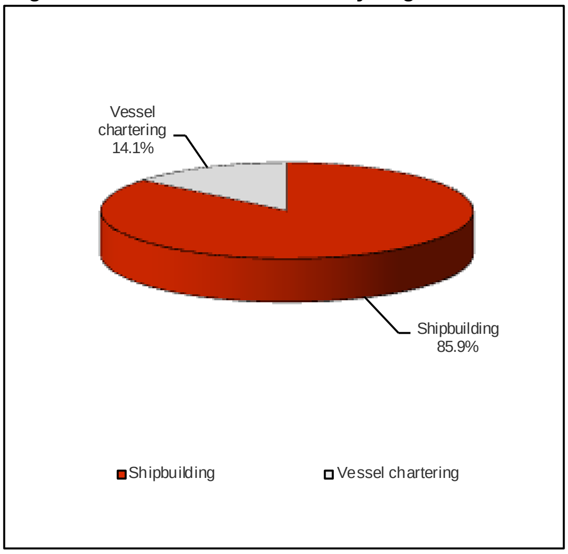
Nam Cheong Ltd

Table 1: Summary Financials

Year End 31st Dec	FY2014	FY2015	FY2016
Income Statement (MYR'mn)			
Revenue	1,928.6	950.0	170.4
EBITDA	306.6	77.9	-140.7
EBIT	289.0	56.2	-163.0
Gross interest expense	53.5	81.6	90.9
Profit Before Tax	303.3	31.0	-42.6
Net profit	301.8	28.5	-42.0
Balance Sheet (MYR'mn)			
Cash and bank deposits	800.1	506.1	301.5
Total assets	3,252.4	3,950.9	4,098.3
Gross debt	1,309.3	1,809.2	1,823.5
Net debt	509.2	1,303.1	1,522.0
Shareholders' equity	1,219.3	1,377.1	1,368.0
Total capitalization	2,528.7	3,186.3	3,191.5
Net capitalization	1,728.6	2,680.3	2,890.0
Cash Flow (MYR'mn)			
Funds from operations (FFO)	319.5	50.2	-19.7
* CFO	161.1	-547.9	-291.0
Capex	6.3	34.0	0.1
Acquisitions	117.4	0.0	0.0
Disposals	145.1	0.1	9.7
Dividend	55.1	84.9	0.0
Free Cash Flow (FCF)	154.8	-581.9	-291.1
* FCF adjusted	127.4	-666.7	-281.3
Key Ratios			
EBITDA margin (%)	15.9	8.2	-82.6
Net margin (%)	15.6	3.0	-24.7
Gross debt to EBITDA (x)	4.3	23.2	-13.0
Net debt to EBITDA (x)	1.7	16.7	-10.8
Gross Debt to Equity (x)	1.07	1.31	1.33
Net Debt to Equity (x)	0.42	0.95	1.11
Gross debt/total capitalisation (%)	51.8	56.8	57.1
Net debt/net capitalisation (%)	29.5	48.6	52.7
Cash/current borrowings (x)	1.4	0.8	0.3
EBITDA/Total Interest (x)	5.7	1.0	-1.5

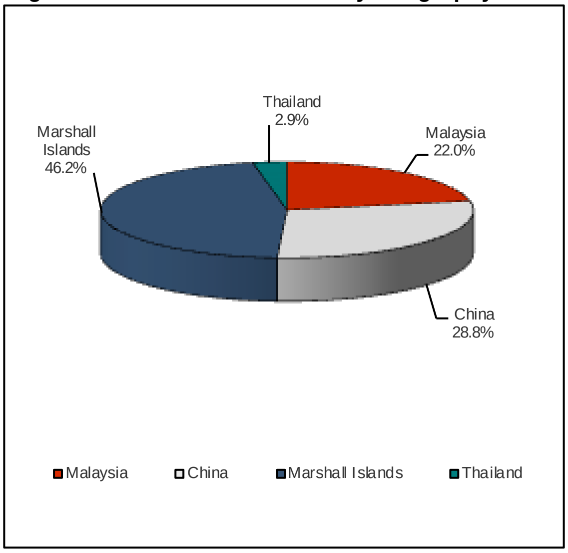
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - FY2016



Source: Company

Figure 2: Revenue breakdown by Geography - FY2016



Source: Company

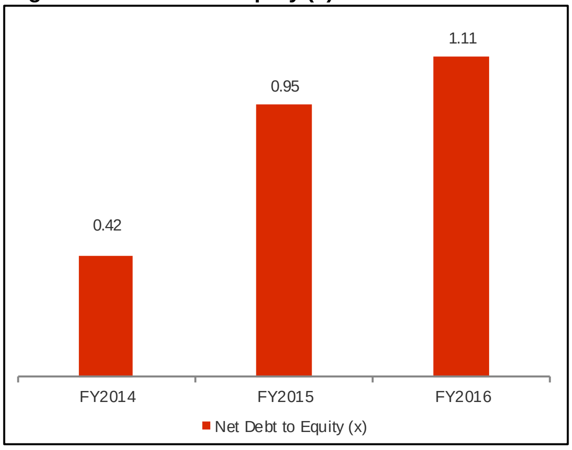
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 3: Debt Maturity Profile

Amounts in (MYR'mn)	As at 31/12/2016	% of debt
Amount repayable in one year or less, or on demand		
Secured	670.2	36.8%
Unsecured	278.6	15.3%
	948.7	**52.0%**
Amount repayable after a year		
Secured	58.8	3.2%
Unsecured	816.0	44.8%
	874.8	**48.0%**
Total	**1823.5**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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