Asia Credit Research

OCBC Bank

Nam Cheong Ltd: Credit Update

Friday, 01 April 2016

The Gloves are Off

- **Order cancellation will hurt**: On 30/03/16, NCL reported that it has received a Notice of Termination/Cancellation from a wholly-owned subsidiary of Perdana Petroleum Berhad ("Perdana"). The vessel being cancelled (Vessel Hull No. SK 316) is one of the two 500-man Accommodation Work Barges ("AWB") ordered by Perdana from NCL in June 2014. The original contract price for the two AWB was USD84mn in total, with the vessels originally scheduled to be delivered to Perdana in 1Q2016 and 2Q2016. Both the AWBs were constructed under NCL's build-to-order ("BTO") model, and were subcontracted out to NCL's partner shipyards in the PRC. In Perdana's filing regarding the matter, Perdana's management stated that the termination was necessary as they have not been able to secure charter contracts for the incoming AWB. Perdana has written-off MYR36.1mn (the 20% deposit for the vessel) during the fiscal year ending December 2015. As NCL was scheduled to deliver the vessel in 2016, it would have recognized significant amounts of revenue (via percentage of completion revenue recognition) prior to the cancellation of the contract (total value of ~MYR181mn). The revenue recognized likely needs to be reversed in the 1Q2016 results. The contract at stake is currently ~15% of NCL's reported gross order book of MYR1.2bn (as of end-2015).

- **Souring of a long-term relationship**: Perdana, an OSV fleet owner with 17 vessels (of which 7 are AWBs) has been a long-time customer of NCL (since 2007). Before the 2014 order, NCL had just sold a smaller AWB to Perdana in 2013. We are concerned over the existing AWB that Perdana still has on order (Vessel Hull No. SK 317) with NCL, as there is no certainty that the contract will remain intact. One solace is that as of end-2015, Perdana only took MYR36.5mn in write-downs over the SK 316's deposit, as well as MY28.1mn in PP&E asset impairments. They have not yet taken write-downs on the SK 317 deposit. Still, in our previous update[1], we have highlighted that order deferments by NCL's end customers were a risk, and that this was mitigated by their long-term relationships that they had in their core market of Malaysia. The outright cancellation of the AWB order by Perdana, as well as NCL publically disputing the cancellation as well as seeking legal remedies may indicate that the dire environment could be driving existing relationships moot.

- **2015 results**: 4Q2015 results showed revenue slumping 53.8% y/y to MYR241.8mn. This was due to the completion and delivery of just two vessels in 4Q2015, compared to six vessels in 4Q2014. There was some gross margin compression as well from 14.6% (4Q2014) to 12.4% (4Q2015). Management indicated that gross margin for shipbuilding was kept intact at 16% (relative to 4Q2014), and that it was the OSV chartering business that generated a gross loss during the period. Due to MYR22.3mn share of losses from associates / JVs, it drove NCL to a pre-tax loss of MYR21.5mn. Otherwise, NCL would have broken even for the quarter. For the full year, total revenue fell 50.7% y/y to

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[1] OCBC Asia Credit - Nam Cheong - Credit Update - 070116

MYR950.0mn. The slump was similar (~50%) for both of NCL's segments. For shipbuilding, just 11 vessels were delivered in 2015, compared to 24 in 2014. Vessel chartering was hurt by both lower utilization as well as poorer lease rates. For the year, NCL managed to eke out a small net profit of MYR27.9mn. Given the current profit trajectory though, we expect NCL to generate a loss in 2016.

- **Cash management improved, liquidity remains pressured**: NCL looked to have improved its cash management, generating positive operating cash flow of MYR26.7mn (4Q2015) during the most recent quarter, compared to an operating cash outflow of MYR564.6mn for the whole of 2015. Due to MYR32.5mn in capex however, NCL generated a small amount of negative free cash flow during the quarter. The cash outlay was met with cash on the balance sheet. As a reminder, NCL's operating cash flow was negative for 2015 due to the large expansion of its inventory when the vessels it ordered (as part of its build-to-stock "BTS") program. Looking forward, with about ~MYR620mn of liquidity required for 2016 BTS vessel deliveries, we expect the legacy BTS vessel orders to continue to pressure liquidity. The Perdana AWB order cancellation would worsen the situation as the AWB will now be held in inventory as well. Interest coverage has plunged sharply to just 1.0x (2014: 5.7x), driven mainly by the sharp fall in EBITDA generation. For now, NCL is able to cure its violation of its interest coverage covenant based on the revised terms post the recent consent solicitation. However, post 30/06/17, NCL will be unable to utilize the cure mechanism should interest coverage fall below 1.0x. Though NCL does not have near-term bond maturities (the next one is SGD90mn in August 2017), it still has about MYR628.0mn in borrowings due in 2016. These are mostly secured vessel financing. Comparatively, NCL had MYR506.1mn in cash as of end-2015.

- **Credit profile stabilized…for now**: During 4Q2015, NCL reduced gross borrowings by MYR62.6mn (part of it was the SGD110mn NCLSP'15 bond redemption). This helped reduced net gearing slightly from 97% (end-3Q2015) to 95% (end-4Q2015). It remains distinctly higher than the net gearing of 42% as of end-2014. Looking forward, with liquidity needs for BTS vessels being delivered, near-term maturities, and with operating cash flows remaining pressured, it could be difficult for NCL to stabilize its credit profile. The key area would be NCL's ability to monetize the BTS vessels sitting in its inventory to reduce the cash locked up in working capital.

- **Recommendation**: NCL managed to wrap up a challenging year with some improvements to its cash burn and stabilization to its credit profile. That said NCL faces the rest of 2016 with looming BTS vessel deliveries pressuring its liquidity, while the weak environment makes it difficult to monetize these vessels. NCL's order backlog continues to shrink as well to MYR1.2bn (2014: MYR1.7bn), before factoring the Perdana cancellation. We will continue to maintain our **Negative** Issuer Profile on NCL. With regards to the NCL curve, we continue to be **Neutral** on a valuation basis. On the bid side, indicative prices reflect the poor market liquidity that the smaller stressed offshore marine issuers are facing, with prices in the 70s and 80s. With the recent improvements in performance seen in 4Q2015, as well as the consent solicitation generating some covenant leeway, we believe investors have some time to observe NCL's performance, rather than sell into a market with thin liquidity. On the offer side though, with the still challenging external environment, and no clear catalyst for credit profile / liquidity improvement, we believe that there are better opportunities elsewhere.

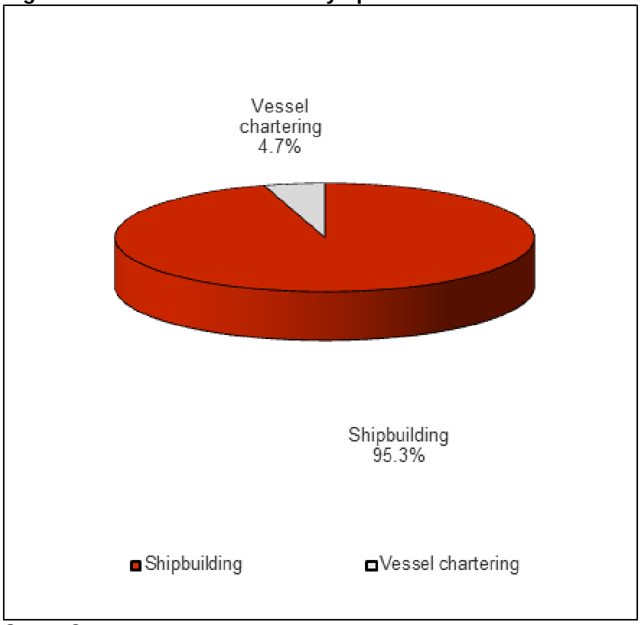
Nam Cheong Ltd

Table 1: Summary financials

Year ended 31st December	FY2013	FY2014	FY2015
Income statement (MYR' mn)			
Revenue	1,257.4	1,928.6	950.0
EBITDA	211.9	306.6	77.9
EBIT	198.9	289.0	56.2
Gross interest expense	33.6	53.5	81.6
Profit Before Tax	199.2	303.3	31.0
Net profit	205.6	301.8	28.5
Balance Sheet (MYR'mn)			
Cash and bank deposits	362.0	800.1	506.1
Total assets	2,179.2	3,252.4	3,950.9
Gross debt	851.2	1,309.3	1,809.2
Net debt	489.1	509.2	1,303.1
Shareholders' equity	938.6	1,219.3	1,377.1
Total capitalization	1,789.8	2,528.7	3,186.3
Net capitalization	1,427.8	1,728.6	2,680.3
Cash Flow (MYR'mn)			
Funds from operations (FFO)	218.7	319.5	50.2
CFO	-229.6	60.9	-564.6
Capex	44.0	6.1	34.0
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	-598.6
Adjusted FCF*	-292.4	31.0	-683.4
Key Ratios			
EBITDA margin (%)	16.9	15.9	8.2
Net margin (%)	16.4	15.6	3.0
Gross debt/EBITDA (x)	4.0	4.3	23.2
Net debt/EBITDA (x)	2.3	1.7	16.7
Gross debt/equity (x)	0.91	1.07	1.31
Net debt/equity (x)	0.52	0.42	0.95
Gross debt/total capitalization (%)	47.6	51.8	56.8
Net debt/net capitalization (%)	34.3	29.5	48.6
Cash/current borrowings (x)	1.5	1.4	0.8
EBITDA/gross interest (x)	6.3	5.7	1.0

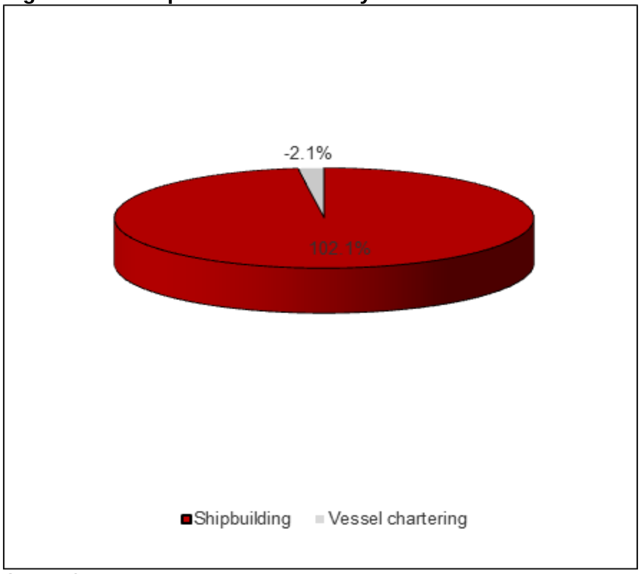
Source: Company, OCBC estimates
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

Figure 1: Revenue breakdown by operations – FY2015



Source: Company

Figure 2: Gross profit breakdown by business line – FY2015



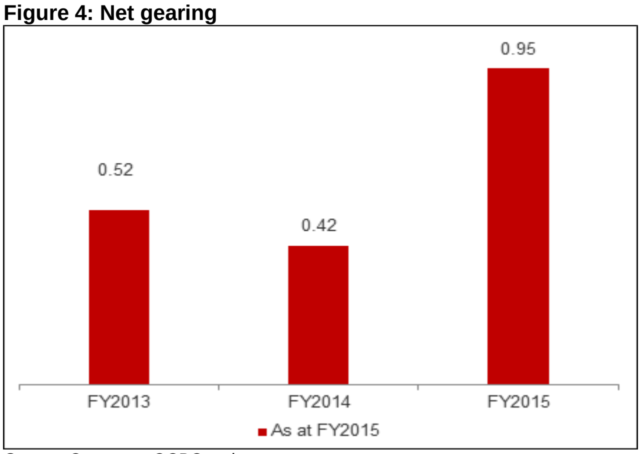
Source: Company

Figure 3: Debt maturity profile

Amounts in MYR mn	As at 31/12/2015	% of debt
Amount repayable		
One year or less, or on demand		
Secured	609.3	33.7%
Unsecured	18.7	1.0%
After one year		
Secured	122.1	6.8%
Unsecured	1059.1	58.5%
Total	**1809.2**	**100.0%**

Source: Company

Figure 4: Net gearing



Source: Company, OCBC estimates