Asia Credit Research

OCBC Bank

Nam Cheong Limited: Credit Update

Monday, 02 October 2017

Let Negotiations Begin

- NCL held its second informal bondholder's meeting on the evening of 07/09/17, providing more details to supplement the tentative restructuring plan first disclosed on 19/07/17. Though the numbers are tentative, these offer the first cut regarding options for bondholders as well as potential recoveries.

- The bonds would be categorized as both non-sustainable (35% of face value) and sustainable (65%). The non-sustainable portion would be converted into shares upfront at USD1 for 17 shares (or ~SGD0.08 per share), or ~75% haircut versus last traded price of SGD0.02. For the sustainable portion, bondholders have the option to (i) exchange their holdings for a new 7Y loan (non-tradable, which amortizes from the 4th year onwards) paying 4% coupon (half cash, half in new shares), (ii) taking cash outright (at a steep haircut of 80% – 95% from notional value) or (iii) converting into shares at USD1 for 34 shares (or ~SGD0.04 per share). Depending on the combination of the options taken, bond recoveries range from 13.5% - 73.6% (management estimates).

- There remain several uncertainties which we expect will be fleshed out when the formal process for the Scheme of Arrangement begins. The **basis for valuation** (for equitizing bondholders) of USD1 for 17 shares needs to be provided, particularly when contrasted against the undisclosed dilution that would result when the majority shareholder's intended injection of ~USD11mn occurs after the Scheme is completed. Structural issues over Singapore HoldCo versus Malaysia OpCo also complicate the restructuring. The tentative schedule is for the Creditors' Meeting (for the vote on the scheme) to be held late November 2017.

Disclaimer: Please note that this report reflects our interpretation of several legal processes, in the context of potential implications for bondholders. It should not be construed as providing legal opinions. Where legal or other professional advice is required in relation to any particular matter, please seek advice from your own legal or other professional advisors.

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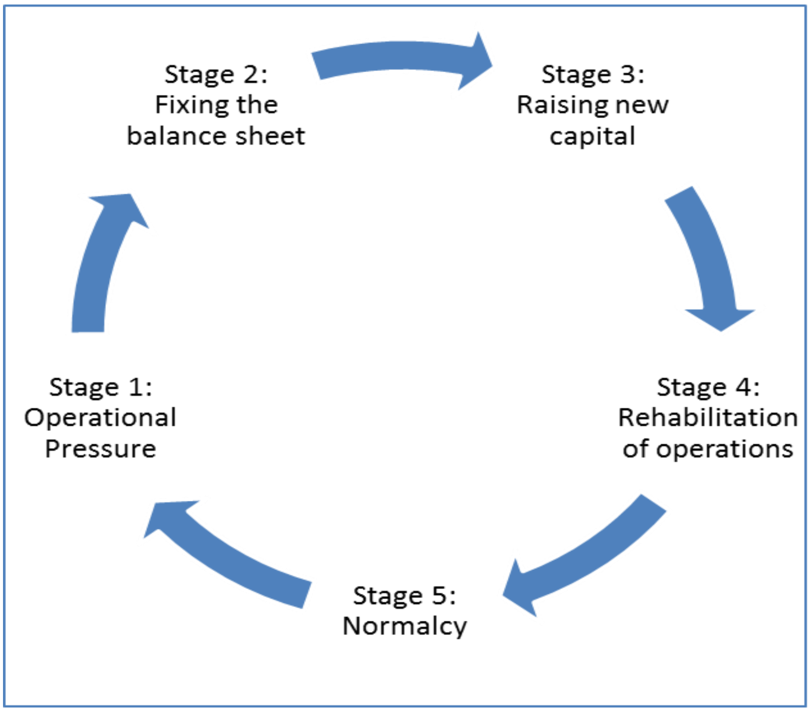
A) What's Next?

On the evening of 07/09/17, NCL held its second informal bondholder's meeting, following up on the first meeting (held on 19/07/17) and providing more details to supplement the tentative restructuring plan. The presentation deck was subsequently made public, and though the numbers provided remain tentative, the assumptions allow for bondholders to have some sense on how the restructuring will be conducted, options available (for bondholders to ponder while the finalized details are ironed out) as well as an estimate regarding timeline. For brevity, this report will build on what we have discussed in our previous report on NCL's restructuring[1]. In essence, NCL intends to conduct a restructuring similar to TT International's, via a Scheme of Arrangement ("SoA").

Restructuring Cycle:



Source: OCBC

The above is a simplified diagram reflecting the stages of distress and renewal that companies go through. When companies fail due to financial pressure, typically they undergo restructuring and exit as going-concerns as this maximizes recoveries (when compared to liquidation). The intuition is straight forward: companies are worth more alive (and generating future revenue / profits off the assets they control) than dead (assets being sold and capital returned to stakeholders).

As it stands, NCL is currently in Stage 2, looking to manage its liabilities. Last year, NCL could be considered to be in Stage 1 when it sought to ease its bond financial covenants in January 2016 (when crude oil prices fell sharply). Peers in offshore marine such as ASL Marine Holdings ("ASL") can be considered to be in Stage 4, having restructured their balance sheet (ASL extended the maturity of its bonds via an out-of-court consent solicitation) and having raised new capital (ASL tapped on SGD99mn new bank facility as well as raised additional equity). ASL is now in the process of managing through the difficult environment.

Do note that it is possible for issuers to "backtrack" in the restructuring cycle. For example, Marco Polo Marine found itself regressing to Stage 2 and is now undergoing a Scheme of Arrangement, despite extending its bond maturities late last year.

In subsequent sections, we will review the tentative plan by NCL in the context of each stage and provide some commentary / analysis on the current terms.

[1] OCBC Asia Credit – Nam Cheong Credit Update 17 Aug 2017

B) Stage 2: Fixing the Balance Sheet

Adjustment of Borrowings:

Type	Amount	Comments
Total Debt	USD424mn	Both secured loans and unsecured bonds
Security	(USD88mn)	Collateral to be sold to pay debt
Unsecured Debt	**USD336mn**	**Includes under-collateralized bank debt**

Source: Company

NCL disclosed that it had USD424mn in consolidated gross debt outstanding (reported MYR1.7bn as of end-1H2017, of which ~MYR600mn was secured). The security for secured loans were estimated to be worth USD88mn (i.e: NCL's loans are currently under-collateralized), with NCL proposing to sell the security and pay down what they can of the secured loans. The balance secured loans outstanding (~MYR248mn) would be treated as unsecured bank claims.

Comments*: For now, NCL is seeking to treat all unsecured claims equal (hence totalling USD336mn) as part of its Scheme of Arrangement, though it should be noted that <u>bondholders currently face HoldCo-OpCo subordination</u>, as the bank loans were issued by NCL's Malaysian OpCos, while the bonds were issued by NCL's Singapore listed HoldCo. In a liquidation scenario, as creditors to the OpCo, the unsecured bank claims will have to be satisfied first, before any residue value can be upstream to the HoldCo for recovery by bondholders. For the rest of this report, it will be assumed that NCL was able to treat all unsecured creditors equally, regardless of entity, <u>though it remains to be seen if NCL will be able to convince OpCo creditors</u>.*

Future Worth

The premise of the restructuring according to NCL's financial advisor, Price Waterhouse Coopers ("PwC"), is that NCL's debt burden is <u>unsustainable</u> given current market conditions. PwC's assessment of NCL's indicative value assuming restructuring success is as shown below:

Description	USD'mil	USD'mil
Existing inventory and deferred sales *(13 vessels)*	150	
<u>Less:</u> Payment to a secured lender *(1 vessel)*	(10)	140
Instalment payments to shipyards *(for 10 additional vessels)* and suppliers	(120)	
Bareboat payment to shipyards	(18)	(138)
Gross charter income over 7 years	234	
<u>Less:</u> OPEX / Overheads	(145)	
Interest on sustainable debt (2018 onwards, 50% deferred)	(33)	56
Value of chartering fleet *(1 existing vessel + 10 additions to fleet)*		162
Indicative value of the Group if restructuring is successful		***220***

Source: Company

The previous table shows an indicative value of USD220mn for the NCL group in aggregate was the basis for NCL's proposal to declare only USD220mn of debt to be sustainable. To arrive at USD220mn in group value post restructuring, the following was assumed:

- Monetization of current BTO / BTS fleet of 13 vessels for net USD140mn.
- Instalment and other payments to partner Chinese yards to take delivery of 10 additional vessels (originally 74 under contract) totalling USD138mn outflow.
- Value of chartering fleet (of 11 vessels after taking delivery) at USD162mn.
- Chartering income net of expenses over 7 years totalling USD56mn.

Comments: *There were very little details disclosed on how the USD220mn was derived (such as the values attributed to the vessels, expected charter rates etc) beyond the broad strokes mentioned above. With the USD220mn being the basis for sustainable debt (and hence debt haircuts) investors deserve more details about how the valuation was derived. As a reference, NCL last reported MYR1.74bn in total assets, compared to MYR2.44bn in total liabilities (as of end-1H2017), and hence negative equity of MYR700mn (largely due to the MYR1.88bn in asset impairments taken during 2Q2017). In contrast, the USD220mn being floated is the estimated realizable value of the firm as projected at the end of 7 years.*

Balancing the Books

Non-sustainable portion	116 (35%)	• Non-sustainable portion which is not supported by value of the Group. • Will be converted upfront at USD1 to 17 NCL shares representing total conversion into approx. 2 billion new shares • This will dilute the existing shareholders immediately by 50%

Source: Company

As the future value of NCL was assessed by PwC to be only USD220mn, USD116mn is deemed to be non-sustainable (out of total projected debt of USD336mn). As can be seen in the table above, NCL seeks to equitize the non-sustainable portion outright. The USD116mn will be converted into shares at USD1 to 17 NCL new shares (or ~SGD0.08 per share). This conversion price is about four times higher than NCL's last traded price of SGD0.02, implying a haircut of 75% on the non-sustainable portion of debt. In other words, for a bondholder with an original notional of SGD250k (with SGD83.3k deemed non-sustainable), there would be a ~SGD62.5k haircut. No basis for the USD1 to 17 NCL shares conversion ratio was provided, though the resultant dilution of existing shareholders by ~50% (including the founding Tiong family) may have been a deciding factor.

Comments: *In accordance with the priority of payments, in a liquidation scenario, should creditors' claims get impaired due to insufficient asset value, shareholders should be wiped out. Given that NCL has reported sizable negative equity as of end-1H2017, this would be the likely outcome in the event of liquidation. As such, should creditors be impaired as part of a restructuring and receive equity in compensation, they should receive the lion's share of equity in the company post restructuring as existing equity would be wiped out in a liquidation. This would be consistent with restructurings seen elsewhere. For example when Tidewater Inc ("TDW"), the world's largest OSV owner, went through its own restructuring[2], aside from other considerations, creditors received 95% in common equity of the restructured TDW. The existing common stock of TDW was cancelled, while original shareholders of TDW received 5% in common equity of the restructured TDW. That being said, it is important to note that the original shareholders of TDW still received something, even though creditors were impaired. The following factors are worth considering:*

[2] https://finance.yahoo.com/news/tidewater-announces-entry-restructuring-support-103300370.html

- *When a company is restructured as a going concern, rather than go into liquidation, even though the company may have negative book value equity today, there remains "option" value, for the company to recover in the future and for the equity to be positive again.*

- *By providing original shareholders with some recovery, it gives these shareholders incentive to facilitate the restructuring. Ultimately certain aspects, such as valuations, can be contentious, and a protracted restructuring benefits no one.*

- *There may be some desire to motivate existing management, especially if they are material shareholders of the company. By allowing them to retain some stake in the company, it would provide alignment for existing insiders to help the company recover.*

- *In the case of a company like NCL, which is both family controlled and operated, the above point becomes more complicated. <u>Creditors have to balance the recovery that they hope to achieve, versus keeping existing managers motivated</u> (assuming that creditors want to keep the involvement of these parties).The TDW restructuring again offers something to consider: aside from the 5% stake, original shareholders were also offered six-year warrants to acquire a further 15% in the restructured TDW (at pre-agreed valuations). As such, original shareholders are able to capture some upside should TDW continue to recover (hence retaining the value of their "option").*

Finally, we note that being equitized may not be the only alternative that creditors should consider for their portion of non-sustainable debt. In the case of the restructuring of TT International[3], rather than common equity, creditors were instead issued redeemable convertible bonds ("RCB"). The terms of the RCB are complex, but in essence annually the RCB could be 1) tendered in a "reverse Dutch auction"; 2) converted into new shares at some pre-agreed price, capped by dilution limits; or 3) reset based on operational tests into sustainable debt. The RCB may offer some middle ground: existing shareholders of NCL (including the Tiong family) are not diluted outright. Instead, the dilution is controlled. In exchange for less potential upside (due to holding less common equity), holders of the RCB benefit from some additional protection in the event of liquidation (should the restructuring fail) due to preference in liquidation above common equity. We note as well that for the TT International restructuring, the full notional amount in RCB was given in exchange for the non-sustainable portion of debt.

Ultimately, the terms for the non-sustainable portion of debt would likely be the most contentious part of the restructuring, and bondholders should negotiate for their rights. After all, NCL requires 75% of creditors, including bondholders to agree to the restructuring. ***<u>In essence, the tentative restructuring plan offers creditors 50% control of NCL, in exchange for forgiving ~35% of debt outstanding. Bondholders need to decide if this is equitable, if not its back to the negotiation table</u>***.

Sustainable portion	220 (65%)	• 7-year term loan subject to a principal moratorium of 3 years with principal repayment from Year 4 onwards (10%, 20%, 30%, 40%) on half-yearly repayment in arrears • Interest at 4% p.a., half of which will be paid as and when due & the balance to be converted to shares at the end of each year • Cash sweep mechanism on excess cash from 4th year onwards

Source: Company

[3] OCBC Asia Credit – Nam Cheong Credit Update 17 Aug 2017

For the sustainable portion of debt, things are more straight forward. NCL is seeking to write off existing debt, and replace all unsecured financial claims with a non-tradable 7-year term loan. There will be no principal repayment for the first 3 years, with an accelerating amortization schedule from the 4th year onwards. Interest on the restructured debt will be 4% (half in cash, half in shares, again at USD1 to 17 NCL shares). A cash sweep mechanism would accelerate payments from the 4th year onwards. Aside from the base scheme, NCL will also offer to buy out the sustainable portion of debt at steep discounts, ranging from 5% ~ 20% recoveries (investors have no control over this as it depends on participation) at a max of USD11mn. Investors can also choose to convert at a rate of USD1 to 34 new NCL shares (still at a premium of double of previous closing price).

Comments: *There needs to be more clarity with regards to the restructured term loan. <u>Is the loan secured</u>? Else investors will be subordinated by any new secured borrowings post restructuring. An annual step up in interest rates after the 3rd year should also be considered, as an incentive for NCL to quickly pay off the loan. Again, the basis for the USD1 to 34 new NCL shares was not given.*

C) Stage 3: Raising New Capital

There is intent for NCL to simultaneously pursue a rights issue as part of the restructuring process, though the rights issue will only occur if the Scheme of Arrangement by NCL is successfully completed. The rights issue will be the vehicle in which the founding Tiong family will inject MYR50mn in fresh funds into NCL. The same MYR50mn (USD11mn) will be the capital used to buyout sustainable portions of debt (should investors choose it). Unlike the conversion rates offered to bondholders, there <u>were no details shared</u> regarding the valuation to be used for the rights issue. The potential dilution was also not disclosed. The circular to shareholders regarding the rights issue as well as EGM are both tentatively scheduled to be before the Creditors' meeting (to vote for the Scheme of Arrangement), though there are no guarantees that it would happen before creditors vote.

Comments: Without details regarding dilution, <u>it would be difficult for bondholders to assess the value of the equity that they are receiving</u>. For example, at the last closing price of SGD0.02 per share, MYR50mn converts into ~800mn in new NCL shares, or <u>roughly 17% of NCL after restructuring</u> (~2bn existing shares, ~2bn from the non-sustainable debt, ~800mn shares from rights issue). If even more rights are issued beyond the MYR50mn, bondholders' equity stake in NCL will be diluted further. Using the TDW restructuring as an example, even though TDW's original shareholders received warrants, the <u>valuation of the warrants were agreed upon beforehand as part of the restructuring</u>, so bondholders were able to assess the value of the consideration that they are receiving in exchange for agreeing to the restructuring. In the case of TT International, the conversion value of the RCBs were also agreed beforehand based on some formula (tied to shares outstanding hence percentage stake) for the initial 5 years, while subsequent conversions were based on market prices of TT International. It is also worth noting that <u>the dilution from the rights issue would also reduce the value of the 2% coupon that is being paid in shares</u> (given that the exchange is fixed at USD1 to 17 NCL shares).

D) Stage 4: Rehabilitation of Operations

Comments*: In our view, based on the brief information shared, it would seem that part of management's strategy is to buy time. It would seem that they are minimizing cash burn by reducing the number of vessels they will take delivery of to the minimum, while selling down on their existing BTO and BTS vessels. In the interim, idle vessels along with the 10 additional vessels to be received will be chartered out to generate some cash flow. When the market turns, <u>the vessel values will appreciate from the current distressed market levels</u>, allowing NCL to monetize and sell its vessels at a better* *valuation. As such, management's strategy is contingent on 1) the overall market for OSVs improving. 2) execution risk of chartering these vessels (when the end client may not be able to pay) 3) receivables from its vessel sales (clients are also stretched and may not be able to pay when the vessels are delivered); and 4) antagonizing their existing customers, which are also OSV owners / charterers. Given how dependent management's strategy is to the environment, it is not surprising that they are asking for 7 years to finish paying down the debt. That said, NCL had historically been able to navigate its domestic market of Malaysia well, and may be able to translate existing advantages and connections they have into new business for their chartering segment.*

E) Tentative Recoveries and Conclusion

For illustration purpose only

For noteholders with SGD250,000 worth of MTNs

	USD'000	*7-year plan (Base scheme) USD'000*	*Cash out basis USD'000*	*Immediate share conversion USD'000*
MTNs of SGD250k	178			
Repayment of principal in the ISRA (approx.)	(5)	5	5	5
Unsecured debts	173			
Non sustainable portion (35%)	61	14 *	14 * (Convert at 17 new shares for each USD1 of debt i.e. approx. 1 mil new shares)	14 *
Sustainable portion (65%)	112			
• 7-year plan - cash		Cash 112		
• Cash out basis - cash			Cash 5 – 22	
• Immediate share conversion - shares				54 ** (3.8 mil shares)
Total recovery		**131 (73.6%)**	**24 – 41 (13.5 - 23%)**	**73 (41%)**

Source: Company

Comments*: The above chart provided by NCL highlights potential recoveries, depending on the options that bondholders choose for the sustainable portion of their debt. As can be seen, the recoveries for the buyout/cash out basis are poorest, following the philosophy that "a bird in hand is worth two in the bush". In fact, immediate share conversion may be preferred as the shares obtained can potentially be liquidated immediately in the market for a hypothetical recovery of 41%, assuming SGD0.02 per share (assuming that NCL's shares resume trading post-completion of the restructuring. As for the first option, recoveries are potentially the highest at 73.6% (and this does not factor the 4% interest paid). However, investors are required to stay invested for 7 years (with no return of principal for at least 3 years) and receiving just 4% for their capital. It also presumes that NCL would be able to turnaround successfully.*

We acknowledge that there is potential for upside from NCL's equity and that with more financial flexibility management would be better positioned to help turn NCL around. That said, it is the prerogative of bondholders to ask for more information so they can be convinced on how NCL intends to move forward. Of particular importance would be information regarding the security (if any) attributed to the restructured loan and the basis for valuation (for the debt-for-equity swap), particularly given the looming dilution from the planned rights issue post implementing the Scheme of Arrangement. In closing, though there are externalities that are beyond bondholders control (such as NCL's OpCo creditors), we believe that the framework for a successful restructuring is in place. What's left is thrashing out the details so that all stakeholders can move forward.

Nam Cheong Ltd

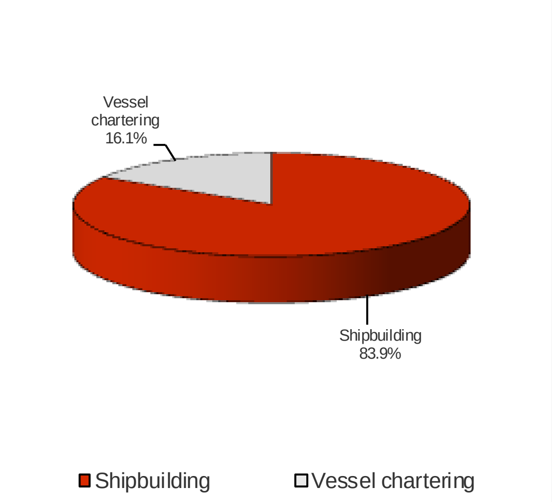
Table 1: Summary Financials

Year End 31st Dec	FY2015	FY2016	1H2017
Income Statement (MYR'mn)			
Revenue	950.0	170.4	169.1
EBITDA	77.9	-12.1	15.1
EBIT	56.2	-34.4	4.2
Gross interest expense	81.6	90.9	16.1
Profit Before Tax	31.0	-42.6	-2,071.6
Net profit	28.5	-42.0	-2,071.8
Balance Sheet (MYR'mn)			
Cash and bank deposits	506.1	301.5	240.6
Total assets	3,950.9	4,098.3	1,740.5
Gross debt	1,809.2	1,823.5	1,700.8
Net debt	1,303.1	1,522.0	1,460.3
Shareholders' equity	1,377.1	1,368.0	-700.3
Total capitalization	3,186.3	3,191.5	1,000.6
Net capitalization	2,680.3	2,890.0	760.0
Cash Flow (MYR'mn)			
Funds from operations (FFO)	50.2	-19.7	-2,060.8
* CFO	-547.9	-291.0	36.7
Capex	34.0	0.1	0.9
Acquisitions	0.0	0.0	0.0
Disposals	0.1	5.1	0.0
Dividend	84.9	0.0	0.0
Free Cash Flow (FCF)	-581.9	-291.1	35.8
* FCF adjusted	-666.7	-286.0	35.8
Key Ratios			
EBITDA margin (%)	8.2	-7.1	8.9
Net margin (%)	3.0	-24.7	-1,224.9
Gross debt to EBITDA (x)	23.2	-151.0	56.2
Net debt to EBITDA (x)	16.7	-126.0	48.3
Gross Debt to Equity (x)	1.31	1.33	-2.43
Net Debt to Equity (x)	0.95	1.11	-2.09
Gross debt/total capitalisation (%)	56.8	57.1	170.0
Net debt/net capitalisation (%)	48.6	52.7	192.1
Cash/current borrowings (x)	0.8	0.3	0.1
EBITDA/Total Interest (x)	1.0	-0.1	0.9

Source: Company, OCBC estimates

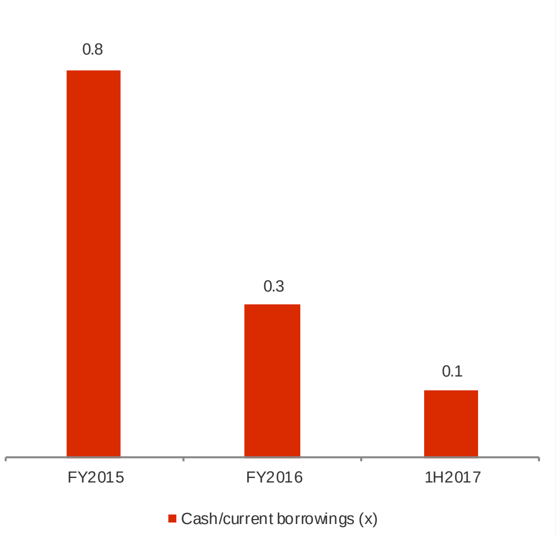
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 1: Revenue breakdown by Segment - 1H2017



Source: Company

Figure 2: Cash/current borrowings (x)



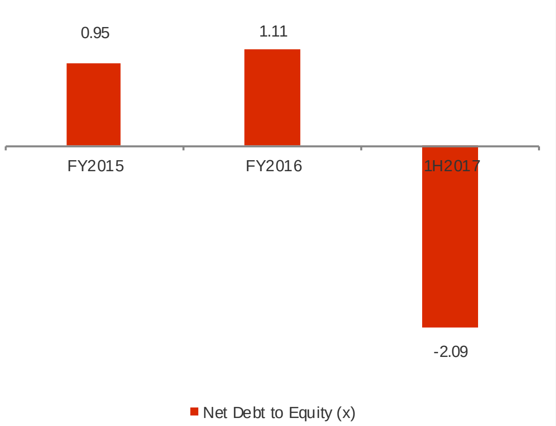
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (MYR'mn)	As at 31/06/2017	% of debt
Amount repayable in one year or less, or on demand		
Secured	596.5	35.1%
Unsecured	1104.3	64.9%
	1700.8	**100.0%**
Amount repayable after a year		
Secured	0.0	0.0%
Unsecured	0.0	0.0%
	0.0	**0.0%**
Total	**1700.8**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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