Asia Credit Research

OCBC Bank

Nam Cheong Limited: Credit Update

Thursday, 17 August 2017

A Preamble

- NCL had held an informal bondholder's meeting on 19/07/17 and indicated its inability to service its borrowings, as well as presenting tentative restructuring plans. On 20/07/17, NCL announced that it would cease payments on all its borrowings, which includes the coupon due on 23/07/17 on its NCLSP'18 bonds. As such, NCL is now formally in **default**. On 15/08/17, NCL announced 2Q2017 results, taking massive impairments and write downs totalling ~MYR2.0bn and wiping out half of NCL's balance sheet. Currently, NCL is in the process of working out more details regarding its restructuring plans, before calling for another meeting with bondholders.

- NCL's tentative restructuring plan involves entering into a Scheme of Arrangement ("SoA"). This would be a court-driven process, in which the incumbent board / management would remain in control through the restructuring process. Part of the restructuring would be to identify outstanding unsecured borrowings and split such borrowings into sustainable and non-sustainable portions, as supported by the projected future value of NCL. The sustainable portion will be retained as debt, while the non-sustainable portion may be equitized into shares in NCL. Given that several details remain unclear, we hope to summarize the tentative plan as presented.

- We also selected a prior Scheme of Arrangement, that of TT International, as a case study for what may happen. In essence, it was highlighted that the restructuring process could be long and complicated, with creditor recoveries dependent on the choices that they make along the way according to the terms of the SoA. We will continue to monitor the situation closely.

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) Background

On 12/07/17, NCL announced that it would be holding an informal bondholder's meeting on the evening of 19/07/17 for the purposes of updating bondholders on NCL's restructuring options. We have previously highlighted[1] that due to the continued weakness in the global oil and gas industry, NCL announced that 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

[1] OCBC Asia Credit – Nam Cheong Credit Update 9 May

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 was in this context that the meeting was called.

The informal bondholders' meeting was private and confidential, but on 20/07/17, the presentation deck used during the meeting was made public via the SGX. In summary, the presentation deck indicated NCL's inability to service its borrowings, as well as presented tentative restructuring plans. On the same day (20/07/17) in a separate filing, NCL announced that it would cease payments on all its borrowings, which included the coupon due on 23/07/17 on its NCLSP'18 bonds. As such, NCL is now formally in **default**.

B) Recent Performance

Massive impairments taken: NCL reported 2Q2017 results on 15/08/17. The most pivotal piece of information would be NCL taking MYR1.88bn in asset impairments and write-offs during the quarter. Specifically, NCL took MYR299.6mn impairment on its PPE, MYR15.5mn on its investment property, MYR8.6mn on trade receivables as well as wrote off MYR1.51bn in inventory as well as MYR47.5mn in prepayments. There was no further information on the impairment loss generated, such as the drivers of the impairments and write downs and no indications in NCL's audited statements ending December 2016. Aside from this, NCL also took a MYR54.4mn impairment on investment in associates (PT Pelayaran Nasional Bina Buana Raya Tbk, with a book value of MYR74.8mn as of end-2016) as well as MYR61.8mn on amounts owed by jointly controlled entities (the two material JVs are Synergy Kenyalang Offshore Bhd and Marco Polo Offshore (IV) Pte Ltd). In aggregate, the impairments and write downs drove NCL to a net loss of MYR2.02bn for the quarter and wiped out shareholders' equity (NCL reported negative MYR700.3mn in equity as of end-2Q2017).

Revenue improvement, margin compression: For the quarter, NCL reported MYR151.2mn in revenue, up 28.8% y/y. The biggest driver of revenue was the shipbuilding segment, which reported a 17.3% increase y/y to MYR133.7mn, driven by the sale and delivery of two vessels during the quarter. Shipbuilding gross margin however compressed sharply to 9% (2Q2016: 19%), likely due to heightened competition in the market. Like the previous quarter, the vessel chartering segment provided some revenue growth, with NCL reporting MYR17.6mn in revenue (2Q2016: MYR3.4mn) due to 3 additional vessels being added to the chartering fleet. Segment gross profit also swung into a small positive at MYR92,000. In aggregate, due to the overall compression in gross margin from 13% to 8% y/y, overall gross profit fell 23.2% y/y to MYR12.0mn. Excluding the impairments mentioned earlier, NCL would have faced a net loss of MYR26.9mn (which includes MYR17.4mn in FX losses). The adjusted net loss would have been an improvement over the net loss of MYR47.5mn in 1Q2017. The q/q improvements should be taken with the context that 1Q2017 results were extremely poor given the MYR17.9mn in revenue generated (2014: MYR1.93bn).

Surprise cash flow improvements: During 2Q2017, NCL reported MYR106.6mn in operating cash flow with NCL monetizing the 2 vessels that were sold during the quarter. A possible reason for NCL's improvements in operating cash flow could be the cessation of payments by NCL to its partner shipyards given the looming restructuring. NCL also paid down MYR63.6mn in net borrowings (potentially related to the vessels sold during the period). As such, NCL generated MYR47.7mn in cash during the quarter, increasing its cash balance. It is worth noting that NCL's net gearing numbers no longer make sense given the negative equity. In addition, all of NCL's borrowings have accelerated and are now payable potentially due to the default.

Setting the stage for restructuring: In our view, the stark impairments and write-downs taken now set the stage for negotiation with various stakeholders as part of NCL's on-going restructuring process. Part of the tentative restructuring plan includes determining how much debt NCL would be able to sustain going forward based on expected future performance, with the non-sustainable portion to be converted into equity, or equity-linked securities. As such, NCL may have an incentive to “mark-to-market” its balance sheet to set the context for restructuring negotiations. As NCL did not disclose the basis for the impairments and write downs, we can draw parallels with impairments taken by NCL’s peers in the offshore marine space. For example, Marco Polo Marine Ltd (“MPM”) which also recently reported its quarterly result (for the period ending June 2017) had also taken ~SGD300mn in impairments and write downs. For context, MPM is also currently in the initial phase of its own Scheme of Arrangement. In summary, MPM had disclosed that due to uncertainties on the ability of MPM to continue as a going concern, its financial statements were more prudently prepared, with its assets being marked down to current market values which are distressed, as guided by shipbroker’s report. We believe that NCL had effected a similar change in the basis of preparation for its own financial statements.

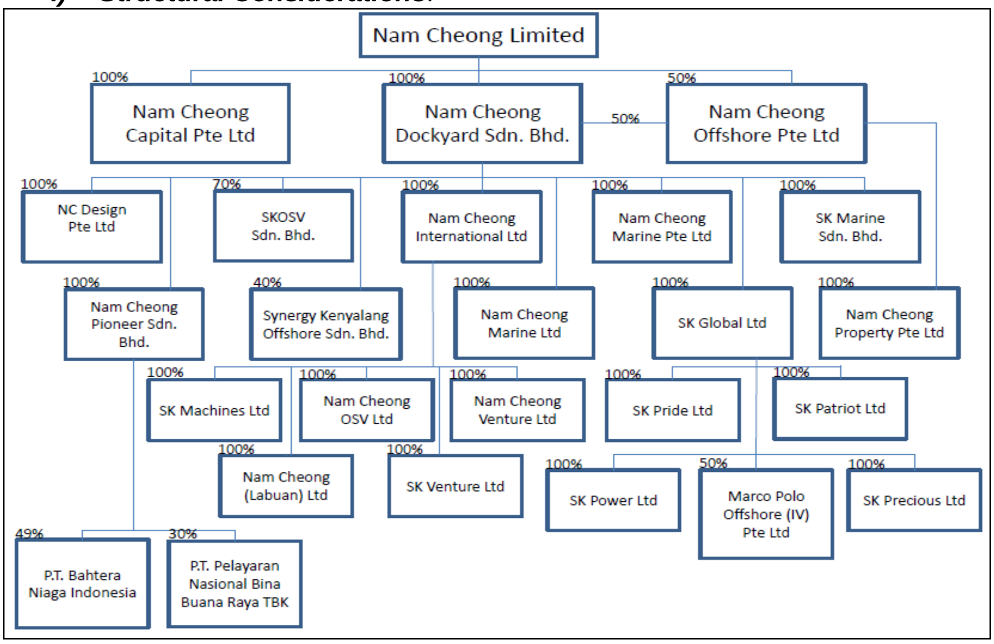
The next steps in NCL’s restructuring would likely be the holding of another informal noteholders’ meeting to communicate the details of the tentative restructuring plan, in order to seek feedback. It is only when NCL has adequate support from creditors (including noteholders) that it would then be able to apply to the courts to initiate the formal process to enter a Scheme of Arrangement.

C) Commentary on Tentative Restructuring Plans

Summary:

- Plan to restructure as a going concern rather than a liquidation.
- Court-driven process (Scheme of Arrangement) rather than out-of-court.
- Debtor-in-possession (incumbent management / directors) rather than 3rd party management, such as under Judicial Management.
- To sell assets to meet secured debt.
- Unsecured debt to be apportioned into sustainable or non-sustainable based on future expected cash flow of NCL. Valuation details still outstanding.
- Sustainable debt: Initial moratorium on principal payment. Restructured interest payment. Excess cash sweep mechanism after end of moratorium period. Voluntary early cash out in exchange for haircut to debt or share conversion.
- Non-sustainable debt: Potentially equitized into new shares in NCL.

I) Structural Considerations:



Source:Nam Cheong Information Memorandum (30 June 2015)

NCL is a Singapore listed HoldCo, with its main operating subsidiary, Nam Cheong Dockyard Sdn Bhd, incorporated in Malaysia. As the HoldCo's main asset is stakes in its subsidiaries as well as amounts due from its subsidiaries, and NCL bonds are issued by the HoldCo (via guarantees on the issuing entity), noteholders face HoldCo-OpCo structural subordination, relative to creditors of NCL's subsidiaries. As such, in liquidation, the creditors (in this case the bank lenders providing secured vessel related financing) of NCL's subsidiaries have to be paid first (or the subsidiaries sold outright for cash) before recoveries can be captured at the HoldCo level. It should be noted that as per NCL's 2016 Annual Report, NCL had provided notional MYR5.1bn in financial guarantees to its subsidiaries, as part of certain banking facilities. As of end-2016, NCL disclosed that should these financial guarantees crystalize, NCL would be liable for MYR1,776.5mn.

II) Legal Framework:

NCL's intent is to enter into a Scheme of Arrangement ("SoA"). SoA is a court-driven restructuring process, whereby the court would make certain judgments as part of the process. Judicial Management ("JM") is another court-driven restructuring process. One of the key differences between the two is that for JM, a third-party administrator, the judicial manager, would be managing the company on behalf of stakeholders. Comparatively for SoA, the incumbent management / board of directors remain in control of the company.

SoA and JM can be contrasted against some of the other restructurings seen in the SGD corporate bond space, such as those done by AusGroup Ltd ("AUSG") and ASL Marine Holdings Ltd ("ASL"). For AUSG and ASL, their bonds were restructured out-of-court, via consent solicitation exercises between bondholders and the issuers. For consent solicitation, the quorum required and percentage vote needed varies according to the trust deeds that dictate the bonds. For SoA, the requirements are more stringent, with the Requisite Majority being 75% in value of each creditor class, or 75% in value across all creditors in aggregate (allowing for cram down on the dissenting classes of creditors, providing that the court deems the cram down equitable[2]). As of end-2Q2017, bonds are ~65% of NCL's total debt. As such, broad noteholder support is required for the SoA by NCL to be successful.

III) Broad Terms

First and foremost, NCL would likely seek a debt moratorium in order to gain time to consider and file its restructuring plan. NCL intends to sell secured assets to repay secured creditors (the bank lenders). For facilities that are under-collateralized (due to the lower realized value of the collateral), the portion not met by collateral proceeds will be treated as unsecured and rank pari passu with the bonds. It is not yet detailed how NCL intends to resolve the issue of HoldCo-OpCo subordination.

For the balance outstanding unsecured debt (including the bonds), based on NCL's valuation / expected future cash flow, a proportion of the debt could be deemed non-sustainable and potentially equitized into new shares of NCL. The portion of debt that is deemed sustainable would likely see 1) principal moratorium for a specific period of time; 2) sweep of excess cash flow to pay down after the moratorium period; and 3) restructured interest payments rather than the existing coupons.

NCL may also offer creditors the option of exiting early via accepting a voluntary haircut on the (sustainable) debt owed to them in exchange for cash or shares. Do note that there has been no details regarding the terms of the debt restructuring, such as the portion of debt deemed non-sustainable. These are potentially areas for negotiation between NCL and the noteholders. NCL had indicated that there will be further informal

[2] OCBC Asia Credit - Changes to Singapore Restructuring 140317

noteholder meetings when details are ready. Given the huge impairments taken by NCL during 2Q2017 results though, with NCL reporting MYR1.74bn in assets supporting MYR2.44bn in liabilities, the non-sustainable portion of debt could potentially be sizable.

A hypothetical example to show how the restructuring could work:

- **Original Notional**: SGD100mn 6% bond due 2018
- **Non-sustainable portion**: SGD40mn, converted into new shares of NCL
- **Sustainable portion**: SGD60mn, new interest at 4%, maturity extended to 2025, with cash sweep paying down principal from 2021 onwards.
- **Early buyout**: Of the SGD60mn, NCL offers to provide 50cents cash for every dollar voluntarily exchange.

Commentary and analysis: Referencing our report on NCL published in May 2017[3], NCL's tentative restructuring plans look to be a blend of Scenario #3 (Equitization) and #4 (Court / System Driven Restructuring). As per Scenario #3, NCL has deemed its gross debt outstanding non-sustainable and hence intends to equitize part of the debt. Unlike in the case of Rickmers Maritime Trust though, NCL is attempting to rely on the court-driven Scheme of Arrangement (rather than via consent solicitation) as per Scenario #4. It is likely that NCL is seeking to leverage off the debt moratorium that results from the SoA. The SoA also offers incumbent management / board continued control over NCL, unlike in the case of Judicial Management. Finally, NCL could also potentially seek super-priority debtor-in-possession financing for working capital to manage its restructuring when undergoing the SoA, though we caution that such financing would typically further subordinate existing creditors. One advantage of SoA is that the creditor support required is high at 75%, which means the burden of proof falls on NCL to convince noteholders to accept its proposals. In addition, the court's involvement would mean that the process would have to be equitable.

D) Case Study: TT International Limited ("TTI")

To give some context on how a Scheme of Arrangement might potentially pan out, we will briefly describe the SoA of TTI.

- TTI is a company involved in the trading of electronic products (the Akira brand), warehouse retail (The Big Box in Jurong), furniture retail (brands include Castilla and Novena) and other businesses. For the fiscal year ending March 2008, it had generated SGD875.7mn in revenue and SGD5.6mn in net profit. TTI was highly leveraged, with a net gearing then of ~156%.
- When the Global Financial Crisis occurred in the latter part of 2008, the credit crunch caused TTI's banks to pull back ~20% of TTI's credit facilities. Prior to this, TTI had already been generating negative free cash flow. The liquidity crunch, coupled with difficult business conditions, resulted in TTI facing debt service issues, causing TTI to trigger events of default.
- By October 2008, TTI held an informal creditors' meeting to seek a consensual restructuring of its borrowings. By January 2009 however, TTI applied and received court approval to propose a Scheme of Arrangement to creditors. TTI had also applied and received a debt moratorium. Originally, the SoA was to be proposed to creditors within 6 months, but TTI obtained an extension. As such the SoA was finally proposed in September 2009.

[3] OCBC Asia Credit - Nam Cheong Credit Update (9 May 2017)

- It is worth noting that for TTI's fiscal year results ending March 2009, TTI took sizable provisions on inventory, receivables, restructuring fees and non-recurring business related penalties, resulting in SGD264.5mn in Other operating expenses (compared to SGD116.1mn the previous year). This drove TTI to realize a loss of SGD230.0mn for the fiscal year.

- As part of TTI's SoA, TTI conducted a "reverse Dutch auction", offering to buy out creditors upfront in exchange for sizable discounts to the debt offered. The balance debt was then distinguished between sustainable debt and non-sustainable debt.

- For sustainable debt, 50% of excess cash per annum generated by TTI was to be used to repay the debt's principal. TTI was to refinance the sustainable debt outstanding by the 5th anniversary of the SoA effective date.

- For non-sustainable debt, the notional amounts will be converted into 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.

- After the SoA was announced, creditors' had to lodge proof of debt and meet to vote on the proposal. TTI's SoA was subsequently approved in December 2009 by creditors, with the court ultimately approving TTI's SoA in March 2010. By October 2011, the non-sustainable debt was converted into SGD139mn in RCB. Sustainable debt stood at SGD81.0mn.

- It is worth noting that subsequently, the final maturity of sustainable debt was extended a few times, requiring the approval of TTI's SoA creditors. It is also worth noting that TTI had proposed to exit its SoA by paying a settlement amount of SGD90mn to its SoA creditors. The attempt in 2016 failed with creditors voting no. Subsequently, in April 2017, TTI had again offered SGD70mn to its SoA creditors. This time, SoA creditors accepted. TTI's SoA is currently on going, as the SGD70mn settlement sum payment had been delayed, and TTI is currently in business disputes with its partner in the Big Box asset.

Commentary and analysis: It is worth noting that despite being in a Scheme of Arrangement, TTI was able to finally complete the Big Box asset in 2014 as well as continue its business. <u>There was no quick resolution to the restructuring</u>, with the recoveries of each creditor depending on whatever they participated in earlier - the "reverse Dutch auction" or converted their RCB into equity along the way. Things have also remained fluid, such as in the case of the final maturity of the sustainable debt being extended a few times. Do note that SoA creditors have continued to have their say in the restructuring. The settlement sum offered also indicated another path to the ending of the SoA.

E) In Summary

NCL had taken the first steps towards the restructuring of its liabilities, including its bonds outstanding. Though details in the numbers are lacking, the tentative terms for the restructuring as presented provide a glimpse of things to come. We would emphasize that certain terms remain elements to be negotiated, and that the burden lies on NCL to convince its creditors to accept any subsequently proposed Scheme of Arrangement. A glance at TTI's SoA has highlighted that the restructuring process could potentially be long and complicated, with recoveries uncertain. That said, SoA creditors' rights have continued to be sustained. With NCL announcing its 2Q2017 results, it is likely that NCL would next call for an informal bondholders' meeting to provide an update of their intent for the restructuring, with the updated financial figures as a basis to initiate discussions. As mentioned in our previous credit update on Nam Cheong (refer to OCBC Asia Credit – Nam Cheong Credit Update 9 May), we have withdrawn our bond recommendation on NCLSP '17s, NCLSP '18s and NCLSP '19s. We will continue to hold our Negative Issuer Profile on NCL and will continue to monitor the situation closely.

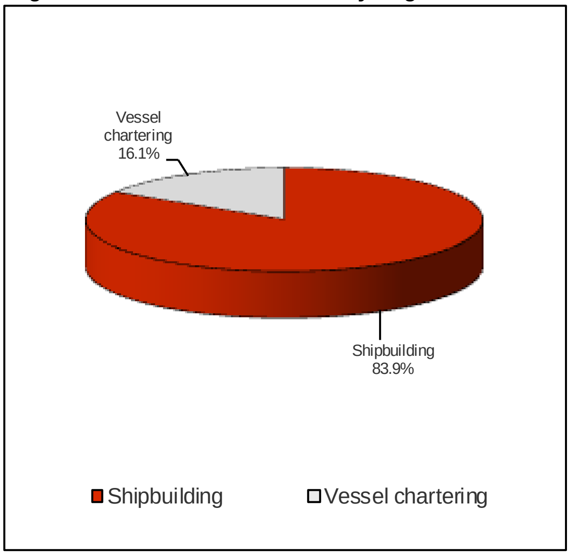
Nam Cheong Ltd

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

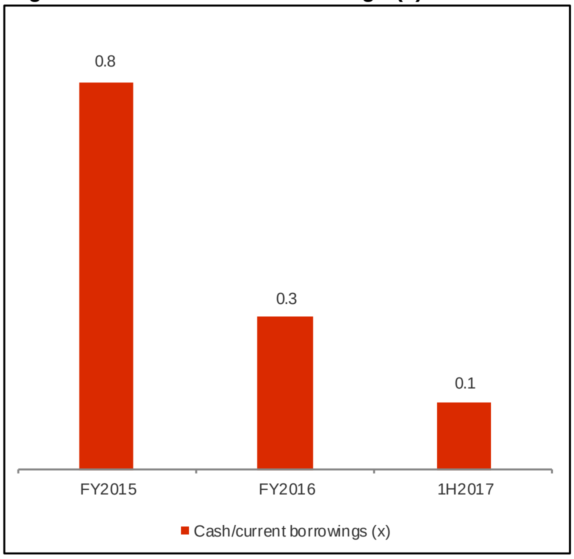
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - 1H2017



Source: Company

Figure 2: Cash/current borrowings (x)



Source: Company

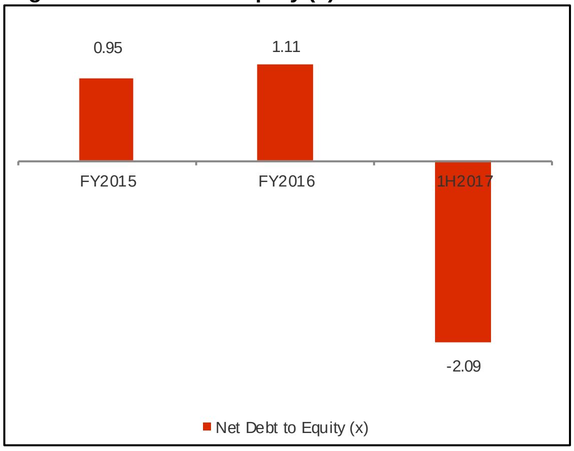
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 3: Debt Maturity Profile

Amounts in (MYR'mn)	As at 31/06/2017	% 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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