Asia Credit Research

OCBC Bank

Pacific Radiance Limited ("PACRA"): Credit Update

Friday, 10 August 2018

A bittersweet deal

- PACRA is proposing a restructuring of its bonds with improved terms and better clarity on how the other stakeholders (bank lenders, shareholders) will be restructured. This is following the rejection of the 1st consent solicitation exercise ("CSE") on 26 Feb 2018 and two further rounds of informal noteholder's meetings on 18 June 2018 ("1st informal meeting") and 18 July 2018 ("2nd informal meeting"). We understand from PACRA that the key terms in the CSE remain unchanged from the 2nd informal meeting proposal and have used this information for the purposes of the report. In the 2nd round of CSE, PACRA intends to redeem the SGD100mn PACRA 4.3% '18s with either (1) shares and some cash payments or (2) convertible bonds. For both options, there will be accompanying 4-year warrants (125k warrants for every SGD250k in notes) and bondholders can also choose to participate in the share placement, for a maximum of SGD10mn at SGD0.014 per share.

  - **Under Option 1:** There will be 5% upfront cash payment with a further 5% cash payment in Year 4 and another 5% cash payment in Year 7. The remaining 85% will be converted to shares upfront at a deemed conversion price of SGD0.101, with no lock-up period on the shares.

  - **Under Option 2:** The notes will be replaced with an equivalent amount of convertible bonds ("CB"). The CB can be converted, at the option of the holder, to shares from Year 2 onwards. Coupons will be 0.25% p.a. with a step-up of 0.25% p.a. after every 3 years. PACRA will redeem 30%, 30% and 40% of CB in Year 7, 8 and 9 if share price is SGD0.075 or higher in the respective years. If no CB has been redeemed or converted at the end of Year 9, there will be 20% payment in cash with PACRA holding conversion rights to convert the remaining 80% to shares at a deemed conversion price of SGD0.112.

- According to the 2nd informal meeting proposal, noteholders would control ~6% of PACRA post-restructuring. Compared to the 1st CSE, this time round the restructuring appears fairer with existing shareholders' stake diluted to ~4.5% (as opposed to 65%). New investors (including bondholders participating in share placement) will control ~74% of the restructured entity, with the balance ~15% held by the banks in exchange for conversion of USD211mn of debt.

- **Recommendation: We recommend noteholders to grant CONSENT to the CSE despite the seemingly still poor (though improved) recoveries offered. Otherwise, PACRA may be pushed into liquidation with uncertain recovery values. Between both options, we recommend bondholders to opt for Option 1. Option 1 provides higher certainty of some recovery with cash upfront while the converted shares provide liquidity upfront. Comparatively, Option 2's conversion price is worse than Option 1, with less flexibility on the timing of conversion. In addition, it may be difficult for PACRA's share price to climb so substantially to achieve full recovery by Year 9 while noting that further upsides may be capped as PACRA holds an option to redeem.**

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OCBC Credit Research

Wong Hong Wei, CFA
+65 6722 2533
wonghongwei@ocbc.com

Analysis of recommendation

Consent, or not to consent?

We opine that not consenting may lead to a less unfavourable outcome in the event of liquidation. Based on PACRA's FY2017 and 1Q2018 results, we identified several issues which may adversely affect recovery rates. As a recap, these include:

- **Negative equity:** As of 1Q2018, PACRA's book value equity stands at a negative USD71.3mn, worsening from end-2017's negative USD57.5mn (3Q2017 equity: +USD250.8mn). The sharp deterioration is mainly due to USD271.2mn impairments in 4Q2017, largely comprise impairments of plant, property and equipment (USD178.1mn) and impairments of amounts due from related companies (USD65.9mn).
- **Negative EBITDA with negative operating cashflows despite higher oil prices:** Operating cashflows before changes in working capital was negative USD2.7mn in 1Q2018 (2017: -USD2.9mn), mainly due to loss before interest, tax, depreciation & amortisation of USD3.6mn in 1Q2018 (2017: -USD2.5mn). After working capital changes, taxes and interest, operating cashflows is worse at -USD6.5mn in 1Q2018 (2017: -USD22.9mn). The rally in crude oil prices did not lead to a turnaround in the offshore support vessel market as the oversupply still persist, as we mentioned in our credit update in Feb 2018.
- **Deterioration of results:** Revenue declined 16% y/y to USD11.8mn, mainly due to the decline in the revenue of Subsea Business by 53% y/y to USD2.1mn (lower charter rates of vessels) while revenue from the Shipyard business also declined by 51% y/y to USD1.6mn. The declines were marginally offset by the increase in revenue from the Offshore Support Business by 12% y/y to USD8.9mn with higher utilisation of vessels.
- **Disclaimer of opinion:** We note that the 2017 annual report has been prepared on a going-concern basis though it is worth nothing that the independent auditors of the company had included a disclaimer of opinion as it is not able to conclude if the use of the going concern assumption is appropriate. The reasons include liabilities exceeding assets with a negative operating cash flow and a net loss in 2017. In addition, USD356.1mn of assets are mortgaged with the banks while the outcome of the restructuring exercise has yet to be concluded. In our view, we could see further impairments in the event of liquidation as asset values may be lower in a forced sale than in use.
- **Substantial assets pledged to banks with significant contingent liabilities may impede recoveries in liquidation:** Bank loans are secured against majority of the assets, which include (1) vessels with net book value of USD292.6mn, (2) escrow mortgages of buildings, ship repair yard and plant and equipment with net book value of USD60.8mn and (3) cash of USD5.2mn. At the group level, PACRA has given corporate guarantees of USD40.2mn as of 2017 (company level corporate guarantees: USD486.6mn).

In addition, despite holding security against majority of PACRA's assets, banks are agreeable to take back just USD221mn (USD100mn upfront, USD121mn retained as bank loans) from USD476mn in loans with the remainder converted to equity (15%-stake in PACRA post-restructuring). Comparatively, bondholders (with no asset security) are likely to see a significantly worse recovery in a liquidation scenario.

Between the options

We think Option 1 looks more favourable than Option 2. In addition to providing higher levels of certainties in recovery, the recovery rates appear better over a broad range of outcomes under Option 1. We think that it is difficult (and even if possible, highly uncertain) for PACRA's share price to recover substantially to achieve full recovery by Year 9 and it is uncertain if PACRA's CB will remain liquid in the years post-restructuring.

Recovery analysis

	Year 0		Year 2		Year 4	
Share price sold (SGD per share)	Option 1	Option 2	Option 1	Option 2	Option 1	Option 2
0 cts	5.0%	0.0%*	5.0%	0.5%	10.0%	1.3%
1.4 cts	16.8%	0.0%*	16.8%	14.2%	21.8%	13.7%
2.8 cts	28.6%	0.0%*	28.6%	26.7%	33.6%	26.2%
7.5 cts	68.1%	0.0%*	68.1%	68.6%	73.1%	68.1%
10.1 cts	90.0%	0.0%*	90.0%	91.8%	95.0%	91.3%
11.2 cts	99.3%	0.0%*	99.3%	101.6%	104.3%	101.1%
15 cts	131.2%	0.0%*	131.2%	100.5%	136.2%	101.3%

*Note: (1) *Zero recovery assumed as shares cannot be converted yet*

Recovery analysis (continued)

	Year 7		Year 8		Year 9	
Share price sold (SGD per share)	Option 1	Option 2	Option 1	Option 2	Option 1	Option 2
0 cts	15.0%	3.0%	15.0%	3.8%	15.0%	24.5%
1.4 cts	26.8%	16.7%	26.8%	17.5%	26.8%	38.0%
2.8 cts	38.6%	28.0%	38.6%	30.0%	38.6%	50.5%
7.5 cts	78.1%	69.9%	78.1%	90.5%	78.1%	101.3%
10.1 cts	100.0%	93.1%	100.0%	99.8%	100.0%	101.3%
11.2 cts	109.3%	102.9%	109.3%	103.7%	109.3%	101.3%
15 cts	141.2%	103.0%	141.2%	103.8%	141.2%	101.3%

As an illustration on the derivation of the above table on recovery analysis, we work based on SGD250,000 face value of bonds. Under option 1, with 5% of cash upfront payment, SGD12,500 cash will be received in Year 0. With 85% of the face value of the bonds converted to shares at SGD0.101, 2,104,000 shares would be received. If this shares were sold at 1.4 cts per share, this translates to proceeds of SGD29,456. The total proceeds from upfront payment (SGD12,500) and sale from share proceeds (SGD29,456) would result in 16.8% recovery value.

In our scenario analysis on the recovery rates, we found that Option 2 would only be more favourable in Year 8 (between 7.5 cts and 11.2 cts share price) and Year 9 (below 11.2 cts share price). We did not include the effects of the sweeteners (ie: the subscription to share placement and warrants). We also assumed that PACRA would exercise its option to redeem Option 2 in the event that the share price exceeds 11.2 cts (and hence cap any further upside), given that the parity value of the CB is ~11.2 cts and it would be accretive for PACRA to issue new shares to fund the redemption. Otherwise, we think it is unlikely for the CB (Option 2) to be redeemed early as the coupons are low, which provide PACRA with cheap funding.

We think there will be challenges for PACRA's share price to climb substantially (e.g. to 7.5 cts and beyond). These include (1) new investors taking ~74% stake in PACRA at a low price, likely at 1.4 cts as per share placement, (2) potential dilution from warrants which are exercisable at 2.8 cts, (3) further dilution from management retention shares (12% on fully diluted basis). Meanwhile, the operating environment of the industry remains challenging.

Other considerations

Seniority: Acknowledging that CB (Option 2) ranks senior to equity (Option 1), protection conferred to CB holders may be minimal. We think it is likely that the CB will be subordinated to secured debt, including the restructured bank debt. In any case, assuming the current restructuring is successful, protection from the seniority provided by Option 2 will only be useful in the off-chance PACRA tip back into restructuring again.

Tipping back to restructuring?: Post restructuring, only USD121mn retained bank loans remains (with extended payment term up to 6 years with interest reduction). We also understand there are no more commitments to buy new vessels, and hence we do not foresee significant cash requirements for PACRA to remain in operations. As such, it is unlikely for PACRA to tip back into restructuring quickly post CSE (if it passes).

Committed amounts by anchor investors: Reported by The Business Times, Mr Sam Goi and several other investors are looking to commit USD85mn in fresh funds. Another USD10mn may be taken up by bondholders via the sweeteners. With PACRA seeking USD120mn total in fresh equity, it has yet to be announced how the balance USD25mn would be committed.

Liquidity of PACRA shares: While difficult to ascertain at this juncture, we think liquidity in PACRA shares may thin as time passes following the lifting of the trading halt (if restructuring succeeds). We had observed this trend from the share volume performance of peer companies such as Marco Polo Marine Ltd and Ezion Holdings Ltd. As such, we see liquidity risks for the CB as the conversion can only take place from Year 2 onwards.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold securities in the above-mentioned issuer or company as at the time of the publication of this report.

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