Asia Credit Research

OCBC Bank

Ezion Holdings Limited: Credit Update

Tuesday, 24 October 2017

Hobson's Choice

- EZI has formally launched the restructuring of its bonds, after holding two rounds of informal noteholder's meetings which updated on the company's circumstances as well as disclosed its intended path of restructuring. In summary, EZI intends to conduct an out-of-court restructuring of its bonds via a consent solicitation. Management had stated the restructuring was necessary in order for EZI to entice bank lenders to refinance and extend existing bank debt, as well as to obtain new working capital. Management had also indicated that they were speaking with potential investors, but refinancing of EZI's existing debt takes priority.

- The proposed terms for the bond restructuring include extending the maturities for the straight bonds (Series 003 to 007) via exchange to either a bond with a 7-year maturity (with redemption premium that starts at 6%) or a bond with a 6-year maturity that matures at par (but is convertible into shares within the first 5 years). The coupon rate for both new bonds will just be 0.25% per annum. For the perpetual securities (Series 008), the choice would either be to switch into a 10-year bond (paying 0.25% distribution and maturing with >7.5% premium), or into a perpetual security (paying 0.25% distribution and convertible into shares during the first 4 years). Financial covenants will also be removed from these new securities. Certain sweeteners were also given for early conversion.

- In aggregate, we consider the current terms lacking. Bondholders post restructuring will be paid a token coupon despite the huge extension to maturity as well as lesser protection from the removal of financial covenants. Though improvements in the final terms share more upside with bondholders, there remains little incentive for the issuer to pay down debt ahead of time should things improve. That said the alternative to agreeing to current terms could be judicial management or liquidation. The extension of EZI's maturities may also facilitate the entrant of new investors.

- **Recommendation: We recommend that bondholders agree to Resolution #1 of the consent solicitation (to restructure the bonds). We also recommend that bondholders take Option B (or Option D for Series 008 holders). Option B offers a shorter maturity by one year, as well as better equity upside should things improve. Option B also allows for liquidity via partial equity conversion to trim down the investor's exposure, should the execution of the turnaround remain difficult. This optionality more than compensates for the redemption premium that Option A would get. We also recommend that investors hold off from Early Conversion. The slight discount and expensive warrants do not compensate for giving up seniority this early in the restructuring, particularly given the significant shareholdings dilution that would likely occur by the time the restructuring is complete.**

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A) Current Situation

Things have certainly spiralled south for EZI. We had downgraded EZI's Issuer Profile from Neutral to Negative in January 2016[1]. Though we appreciated EZI's fleet of modern liftboats, we were concern about EZI's service rigs then. Some of these rigs were older jackup drilling rigs which EZI purchased second-hand from contract drillers such as Ensco. At that time, though these drilling rigs were purchased with contracts attached, we were concerned that it could be challenging for EZI to find new charters, or to obtain good rates for those rigs, given the glut of newbuild jackup rigs in the market. Though management had attempted to repurpose some of the rigs for maintenance work, or even for accommodation, based on EZI's recent disclosures about its fleet utilization (this information was not previously publically available), it would seem that attempts to lease out its fleet had been mixed.

	Liftboats	Rigs	OSV	Tugs & LCTs	Barges	Total
Total	14	20	6	15	24	79
Deployed	5	3	3	0	6	17
Deployed, in arrears	0	6	1	1	1	9
To be Deployed in the next 6 to 12 months	5	1	0	2	0	8
Not Deployed	2	10	2	12	17	43
Pending Delivery	2	0	0	0	0	2

Source: Company, 2nd Informal Noteholders Meeting Presentation

Significant Challenges for Service Rig Fleet

As the service rigs and liftboats make up the bulk of EZI's balance sheet, and drive most of EZI's cash flow generation, utilization and charter rates are crucial to operational performance. Given the stress seen in the offshore marine environment, client stress is another factor which could impede cash flows. As can be seen above, for EZI's service rigs, only 3 of EZI's service rigs (15%) are utilized and not in arrears. EZI has a further 6 service rigs that are deployed, but in arrears. We believe that 3 of these deployed rigs in arrears are likely to be those formerly in joint venture with Swissco Holdings ("SWCH"). Last October[2], SWCH had disclosed that the 3 drilling rigs 50% jointly owned with EZI (the GSP Atlas, GSP Fortuna and GSP Orizont, collectively known as the GSP rigs) were on charter, but the charterer had not been making payments. What is tricky is that if these are the same rigs that are in arrears, the charterer would not have been making payment for more than a year (potentially requiring provisions on the receivables). In addition, EZI has 10 service rigs (50%) that are currently idle. Even if cold stacked, the financing on these rigs need to be serviced. With the still sizable glut in newbuild drilling assets, it might be sometime before these older rigs get deployed (assuming that they are not scrapped).

Poor Liftboat Utilization

The main saving grace for EZI versus its other offshore marine asset owner peers was its liftboat fleet. Liftboats benefit from being focused on the maintenance part of upstream activity, rather than the more cyclical exploration part. As maintenance work is

[1] OCBC Asia Credit – Singapore 2016 Credit Outlook (7 Jan 2016)
[2] Swissco Holdings Limited – Informal Note holders meeting (10/10/16)

required regularly, demand was expected to be more sustained compared to drilling rigs. However, EZI's liftboat fleet was affected by delays to maintenance work, with clients deferring work for as long as they can to preserve cash flow. In addition, there were also signs that liftboats were becoming oversupplied as well. For example, Seacor Marine Holdings reported[3] that day rates for its liftboats fell from USD16,822 (for 3Q2016) to USD10,315 (for 2Q2017). EZI's reported utilization was discouraging at just 5 out of 12 (~42%).

Loose Ends

We had previously highlighted our concerns regarding the SWCH joint venture when EZI disclosed their 4Q2016 results[4]. Strategic Offshore Limited ("SOL") was the joint venture which held the 3 GSP rigs. EZI had booked SOL's carrying value at USD60.5mn as disclosed in EZI's 2015 Annual Report. In addition, it was disclosed that EZI made USD55.5mn in shareholder loans to its JVs, with SOL being the only material JV that EZI had. Based on EZI's 2016 Annual Report, it was disclosed that EZI now booked SOL's carrying value at USD73.6mn (based on equity accounting), and that shareholder loans to its JVs increased to USD77.3mn. As SOL's GSP rigs had not been cash flow generating (given that the charter was in arrears), the shareholder loans may have been provided to service the vessel financing in the JV. EZI had subsequently acquired the balance 50% of SOL[5], and promptly sold it to a third-party. There has been no update regarding SOL since. We note that EZI has USD281mn in contingent liabilities due to joint ventures (which includes SOL).

In summary, EZI faces significant operational challenges. Though recently updated management numbers show stronger expected utilization:

Deployment of Vessels	Liftboats	Service Rigs	Offshore Logistics Vessels	Total
Deployed Vessels	9	2	8	19
To be Deployed Vessels (including two Liftboats under construction)	5	6	2	13
Deployed Vessels, in arrears	0	6	0	6
Undeployed Vessels	0	6	35	41
Total	14	20	45	79

Source: Company, Ezion Consent Solicitation Statement

We would caution that assumptions made for the above table were more aggressive; As an example, the 6 service rigs to be deployed (up from zero as of end-2Q2017) are expected to be deployed within 24 months (compared to 6 – 12 months for the prior table). As such, we believe that things remain challenging for EZI, and that we may see more impairments / provisions to come. During the most recent quarter (2Q2017), EZI had generated negative free cash flow, in part due to its capex needs. Liquidity was also tight, with EZI reporting USD93.7mn in cash balance (as of end-2Q2017), compared to USD340.5mn in near-term borrowings (of which USD251.5mn is secured financing likely to be vessel financing). Coupled with the limited covenant headroom it had for its interest coverage covenant, EZI's current attempts to restructure its liabilities are not unexpected. It is in this context that we consider the restructuring proposal.

[3] http://www.nasdaq.com/press-release/seacor-marine-announces-results-for-itssecond-quarter-and-six-months-ended-june30-2017-20170810-01531
[4] OCBC Asian Credit Daily - 23 February 2017
[5] OCBC Asian Credit Daily - 14 August 2017

B) Summary of Terms

EZI is seeking to restructure its bonds out of court via a consent solicitation (versus a court-driven process such as SWCH's Judicial Management or Nam Cheong Limited's Scheme of Arrangement). It is more similar to ASL Marine Holding's restructuring (which was completed at the beginning of 2017). EZI intends to redeem all outstanding Series 003 – 007 bonds, in exchange for new bonds (Option A or B). For perpetual holders (Series 008), EZI would offer either to exchange for a new bond (Option C) or for investors to hold a restructured Series 008 bond (Option D). It should be noted that Series 009, the bonds backed by a committed funding facility, are not part of the current consent solicitation. We have summarized the main terms below, and will provide our commentary.

Straight Bonds (Series 003 – 007)

Terms	Original	Amendments (common to both options)
Coupon	Varies	All to be reduced to 0.25% per annum
Maturity	Varies	Extended: Option A (7 years), Option B (6 years)
Covenants	Varies	To be removed. Negative Pledge loosened.

***Comments**: EZI is seeking to impose onto bondholders everything but a haircut to principal.*

- *The coupon will be cut to a token amount. This is not unreasonable if the basis is to conserve cash, but EZI could have paid coupon in kind in the form of more shares. The lack of coupon step-up with the progression of time means little incentive for the issuer to call the bonds ahead of maturity.*
- *Maturities are to be extended significantly with no mechanism for accelerated repayment should things improve (such as excess cash sweeps).*
- *Covenants removed outright means less protection for bondholders if things continue to deteriorate.*

The holders of Series 003 – 007 bonds have a choice of the below two options (or a mixture of the two if they hold more than one lot of SGD250,000):

Option A	Straight Bond. Redemption Premium of 6% (upside dependent on EZI's stock price). Callable by issuer after 5 years.

***Comments:** Investors are being paid a trivial amount for locking up their capital for 7 years. Assuming no upside from EZI's stock price movement, effective yield to maturity ("YTM") would be ~1.1% (or just 0.25% per year if EZI defaults before maturity). Even using EZI's example where it illustrated its stock price doubling from reference levels (e.g. SGD0.28 reference price, and SGD0.56 at redemption date), the redemption premium would increase to just 12%, which implies ~2% YTM. It is highly likely that the Option A bonds would plunge sharply in price after issuance, as it is not dissimilar to zero coupon bonds (which should trade at discounts). If we generously apply a 5% required yield (rough average of EZI's existing bond coupons), based on the 7 year maturity and 6% redemption premium, the bond price should fall to 76.5 from 100.*

Option B	Convertible during first 5 years. Redeems at par. Conversion price of SGD0.2763 per share or higher (resets every 6 months). Callable by issuer if outstanding < 10% of issue.
Early conversion sweeteners: A) If converted during the first 60 days from issue, 10% discounted conversion price of SGD0.2487, plus 50,000 warrants (24 month expiry from restructured bond issue, strike of SGD0.2763, aka “bond warrants”) per SGD50,000 converted. B) If converted after first 60 days, but before six months after issue, receive 25,000 bond warrants per SGD50,000 converted.	

Comments: *Compared to Option A, Option B investors are forsaking the redemption premium in exchange for a conversion right as well as an early maturity by one year. Unfortunately, there is a minimum conversion price of SGD0.2763 per share. Management indicated that this SGD0.2763 per share was a 10% discount of the 6-month VWAP of EZI's shares right before its shares were halted. That said, we believe this minimum conversion price to be too high given the significant dilution that could potentially occur. For example, management intends to issue a further 1.24bn warrants to existing shareholders (expected 18.8% shareholding on a fully diluted basis assuming 100% exercised). The above does not include dilution from the strategic investors which EZI intends to attract, nor warrants which EZI may issue to bank lenders as an incentive to aid EZI in its refinancing. In our view, the 6-month reset mechanism should not have a minimum conversion price of SGD0.2763, in order to be more equitable to Option B bondholders. As we consider the SGD0.2763 per share to be expensive, given the potential dilution that may occur, the early conversion sweeteners do not make sense to us. It should be noted that the minimum conversion price will not be adjusted lower due to dilution arising from the exercise of existing warrants, bond warrants, intended new warrants to shareholders and incentive warrants to lenders.*

Perpetual Securities (Series 008)

Option C	Straight Bond (unsubordinated unsecured). Coupon of 0.25%. Redemption. 10-year maturity. Premium of 7.5% (further upside dependent on EZI's stock price, see Option A). Callable by issuer after 5 years.
Option D	Perpetual Security (subordinated unsecured). Distribution rate of 0.25%, with step-up of 1% per annum after 7 years. Callable after 7 years at par. Convertible at the same terms as Option B (for the first 4 years), and enjoys the same early conversion sweeteners.

Comments: *In our view, Series 008 holders have a better deal compared to Series 003 – 007 holders. In a liquidation scenario, as subordinated securities, it is likely that Series 008 holders will be wiped out. Now, if they choose Option C, investors actually get moved up the capital structure to unsubordinated unsecured. This means that they will enjoy the same seniority as Option A and Option B bondholders in a liquidation scenario. As for Option D, investors enjoy the same conversion terms as Option B for the first four years (despite remaining subordinated).It should be noted however, that if Option D holders did not convert their holdings during the first 4 years, EZI would have very little incentive to call the perpetual securities as the distribution rate is very low, and that the step-up from year 7 onwards is small with each passing year.*

C) Analysis and Recommendation

EZI's bondholders basically have to make two decisions: First, whether to consent to the proposed restructuring. Second, which option to take in the event that the restructuring goes ahead.

Consent Solicitation

In aggregate, we consider the current terms lacking. Bondholders post restructuring will be paid a token coupon despite the huge extension of maturity as well as lesser protection from the removal of financial covenants. There could potentially be further subordination by senior secured debt, as hinted by the proposed loosening of the Negative Pledge (which would facilitate the raising of more secured debt). Other restructurings, such as those done by ASL Marine Holdings, give investors a bit more comfort by providing collateral in exchange for providing the issuer with relief.

Though we acknowledge that improvements in the final terms (versus the tentative terms first floated during the 2nd informal noteholders' meeting) share more potential upside with bondholders, there remains little incentive for the issuer to pay down debt ahead of time should things improve. This allows EZI to enjoy low cost of debt at the expense of bondholders. The lack of excess cash sweep and lack of punitive interest step-up (be it cash or in shares) supports our view.

That said, what are the alternatives which bondholders have, assuming that the restructuring of EZI's bonds are inevitable? Voting no may result in improved terms, but in our view 1) bond maturity extension is needed given the company's liquidity situation 2) reduction in cash interest needed in the short-term to preserve liquidity 3) demanding for collateral or cash sweep mechanisms may be more equitable, but may drag out the restructuring process. As such, even if terms are improved, the broad strokes of the restructuring would likely remain.

Voting no may also result in acceleration by other creditors, which may push EZI to seeking court protection, resulting in either Judicial Management or Scheme of Arrangement. A court-driven process may potentially result in higher recoveries for bondholders, but the spectrum of outcomes is also a lot wider. A court-driven process would likely take a longer time to resolve, while potentially triggering certain contingent liabilities. As such, even though we believe that terms for bondholders could be better, bondholders are effectively facing a Hobson's Choice. **We would recommend that bondholders consent to Resolution #1 of the consent solicitation, agreeing to the bond restructuring.**

Optionality is Key

With regards to which option to choose when considering the restructuring, for Series 003 – 007 holders, **we would recommend Option B for the following reasons**:

- **Regarding Upside**: Option B offers more upside than Option A. In the event EZI recovers and its stock rallies, the convertible option in Option B would be worth more than the redemption premium provided by Option A.

- **Regarding Downside**: As the option sits with the bondholder, should EZI continue to underperform, Option B bondholders can choose to not convert their stakes, and in a restructuring they would be pari passu with Option A bondholders.

- **Regarding Liquidity**: Post restructuring, both Option A and Option B bonds are likely to remain illiquid (at least until EZI's operations improve decisively). For Option A in particular, the bond would likely trade to a sharp discount (as mentioned earlier as it is effectively a zero coupon bond). For Option B bonds, it is likely that the bonds would also trade at a discount (but higher than Option A bonds due to the embedded option). As such, trading out of these bonds would likely result in a loss. Comparatively, Option B bonds have the additional option of converting into equity, which is likely to be more liquid. This in turn would be dependent on the market price of EZI's stock at that point in time (subject to the minimum conversion price mentions earlier).

- **Regarding Risk Management**: As each original lot of SGD250,000 would be further divided into lots of SGD50,000, Option B holders have the additional option of converting part of their holdings into equity and monetizing earlier via sale in the equity market. This is particularly important should EZI continue to underperform, and exiting via secondary bond markets not possible. Though recoveries would likely be poor, at least investors have the option to do so if their personal circumstances require it.

With regards to Series 008 holders, given the conversion feature under Option D, we would **recommend taking Option D** as the base case, for similar reasons. The main difference is that we would be giving up the seniority which Option C offers. Furthermore, it is highly likely that holders of Option D would have to convert into equity during the first 4 years, as beyond that the perpetual security no longer converts and EZI would have very little incentive to call the instrument. Comparatively, Option B holders are better positioned as they can choose to hold to maturity if market price of EZI's stock makes conversion unattractive.

Finally, we would recommend that investors **not to participate in the early conversion sweeteners offered as part of Option B and D**. As mention, the slight discount to the expensive conversion price and likely out-of-the-money warrants are inadequate given the significant dilution that shareholders are likely to face as part of EZI's restructuring. Ultimately, the options embedded in the Option B and D bonds have a lot of potential value given their long life. Furthermore, Option B holders should not give up the protection that their seniority as an unsubordinated unsecured creditor provides so early in the restructuring. The early conversion sweeteners only makes sense if investors value a quick recovery via an exit in equity markets, at the detriment to ultimate recoveries.

In summary, we recommend that affected investors consider agreeing to Resolution #1 of the consent solicitation, and to favour Option B or Option D depending on your holdings. We would also recommend investors avoid participating in the early conversion sweeteners offered, to maximize flexibility depending on the future performance of EZI.

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