Asia Credit Research

OCBC Bank

Nam Cheong Limited: Credit Update

Wednesday, 06 December 2017

Bitter Compromise

- NCL had made public a FAQ sharing certain details regarding its Scheme of Arrangement (which has not been publically disclosed). A review of the terms is made, with the assumption that details not provided would be similar to those discussed as part of the previous informal bondholders' meetings. The broad form of bond restructuring remains similar: 35% of notional is deemed to be non-sustainable and will be converted into equity. The balance 65% would be exchanged into a 7-year term loan which amortizes from the 4th year onwards and pays 4% coupon (half in cash, half in shares), or bought out via cash.

- The changes include improved terms, such as the conversion of non-sustainable debt at SGD0.045 per new share (compared to SGD0.08 previously). This, however, remains poorer compared to the proposed 1-for-1 rights issue share price of SGD0.014 (the price which the majority shareholder intends to participate at subsequently). Bondholder options have also been simplified: Assuming support for the scheme, for the sustainable portion of debt bondholders have to choose between 1) term loan option or 2) cash out option at steep haircut ranging from 80% - 95% depending on participation.

- Estimated notional recoveries are ~76% at the end of 7 years (for the term loan option) or ~17.5% in cash and shares upfront (taking the average of the cash out option). These estimates don't consider coupon, share price movement, time value of money and default risk. In aggregate, though the conversion price for the non-sustainable portion of debt is inequitable when compared to the last trading price of NCL (let alone the rights issue share price), structurally bondholders are ill-positioned due to HoldCo-OpCo subordination. Though improvements to conversion price are possible, this should be balanced against the risk of the Scheme of Arrangement failing, with liquidation being the worst possible outcome.

- **Recommendation: Balancing various factors, we recommend that bondholders vote FOR the Scheme of Arrangement proposed by NCL. In addition, we recommend that bondholders take the Term Loan Option over the Cash Out Option given the higher ultimate recoveries, unless immediate liquidity is desired (at the cost of a high haircut).**

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) Current Situation

On 24/11/17, NCL had announced that it had despatched to Creditors the Scheme of Arrangement (dated 23/11/17) as well as other various related documents as part of their restructuring process. The Scheme Meeting for Creditors to vote on the Scheme of Arrangement will be held on 24/01/18. There are earlier deadlines (if applicable), which include submission of the Voting Instruction Form as well as the Proof of Debt by 14/12/17, as well as the deadline to submit the Proxy Form by 19/01/17. As it stands, the actual Scheme of Arrangement document has not been made publically available for review.

The situation changed yesterday, when NCL filed to the SGX a FAQ[1] sharing certain details regarding its Scheme of Arrangement. Some of the details provided included terms there were previously not publically disclosed, and are materially different compared to the tentative terms shared during the second informal bondholder's meeting. In addition, NCL had also filed a separate document to detail its non-underwritten rights issue (as part of its broader restructuring plan). As such, we have attempted to reconcile what we gleaned from prior company disclosures, with the key terms disclosed in the FAQ. A review of the terms is made, with the assumption that details not provided would be similar to those discussed as part of the previous informal bondholders' meetings. As such, this report is based on the partial information (that was disclosed publically), and should be read in conjunction with our previous reports on the NCL restructuring~~(~~, such as OCBC Asia Credit - Nam Cheong Credit Update (2 Oct).

B) Key Terms of the Scheme of Arrangement

The broad form of the Scheme of Arrangement looks similar to the tentative plan proposed during the second Informal Noteholders Meeting (held on 07/09/17). In general, things have been simplified (fewer options for investors to consider) and certain terms sweetened. Details regarding the planned subsequent rights issue were also shared.

As a recap, NCL intends to sell collateral to pay down its secured debt. As the secured debt is currently under collateralized, the balance of such debt would be treated as the same class as other unsecured creditors (including ~SGD365mn in notes outstanding). As indicated by NCL previously, 35% of NCL's unsecured debt is deemed non-sustainable while the 65% balance is deemed sustainable. The ratio has been held the same as the tentative terms. As described in the FAQ:

"The value of the Group (based on cash flow projections and estimated valuation of the assets), if it was allowed to continue operating as a going concern, is lower than the total unsecured debts (both banks and bonds) by approximately USD 120 million. The USD 120 million unsecured debt in excess of the value of the Group represents the Non-Sustainable Debt that is not supported by the value of the Group and thus the Group has no means to repay this amount. This USD 120 million represents approximately 35% of the total unsecured debts"

In other words, this ratio will be applied across the ~USD343mn in unsecured debt (including the notes). I.E. For SGD250k note, SGD87.5k is deemed non-sustainable while SGD162.5mn is deemed sustainable.

[1] http://infopub.sgx.com/FileOpen/NC%20-%20FAQ.ashx?App=Announcement&FileID=480959

1. **Non-sustainable debt (35% of notional)**: To be converted into equity at USD1 for 30 newly issued NCL shares, or implied value of SGD0.045 per share (versus SGD0.02 per share last closing price on 20/07/17 right before NCL's trading halt). Terms have been improved versus the SGD0.08 per share originally proposed. However, there remains no valuation basis provided for the SGD0.045 value per share.

2. **Sustainable debt (65% of notional)**: <u>Two mutually exclusive options</u>:

   a. **Term Loan Option**: To be exchanged into a 7-year unsecured term loan (tentative terms had stated that these are not tradable) that amortizes semi-annually from the 4th year onwards (4th year: 10% principal repayment, 5th year: 20%, 6th year: 30%, 7th year: 40%). Pays 4% annual coupon (50% in cash, 50% in shares issued at SGD0.045 per share). The FAQ explicitly shows the repayment schedule based on a SGD250k notional:

Year			
2021	:	10% x SGD 162.5k = SGD 16.3k	(equivalent to USD 12.0k)
2022	:	20% x SGD 162.5k = SGD 32.5k	(equivalent to USD 23.9k)
2023	:	30% x SGD 162.5k = SGD 48.8k	(equivalent to USD 35.9k)
2024	:	40% x SGD 162.5k = SGD 65.0k	(equivalent to USD 47.9k)

   Source: Company

   b. **Cash Out Option**: In exchange for a deep haircut, investors may recover 5% - 20% of the <u>sustainable debt</u> they hold for cash outright. Actual recovery is uncertain as it depends on the level of participation of bondholders, as the funds for the Cash Out Option are limited to MYR50mn. Higher participation in the Cash Out Option means lower recovery.

In aggregate, from the bondholders' perspective it would seem that the restructuring decisions to be made have been simplified (tentative terms such as the share conversion option for the sustainable portion of debt has been removed). The bondholder has to decide if he/she is **FOR** or **AGAINST** the debt restructuring proposed by NCL. In the event that he/she is FOR the Scheme of Arrangement, he/she will need to decide between the **Term Loan Option**, or the **Cash Out Option**. For the Scheme of Arrangement to be passed, NCL needs the approval of the Requisite Majority (representing 75% in value of NCL's creditors, or all class of creditors).

C) Regarding Equity and Shareholding

To fund the Cash Out Option, as well as to raise working capital, NCL intends to conduct a non-underwritten 1 for 1 right issue (there are about 2.1bn shares outstanding). The rights issue will only be conducted if the Scheme of Arrangement is approved. The issue price for each rights share is expected to be SGD0.014 per share (or 30% discount to the last trading price of SGD0.02, and sharply lower than the SGD0.045 value used to equitize bondholders).

The major shareholder (Tiong) has committed to subscribe to his pro-rata share of rights (1.07bn shares or ~SGD15.0mn worth) as well as excess rights subject to a cap of MYR50mn investment in aggregate (~SGD16.5mn). In essences, Tiong is committing to inject MYR50mn in new capital into NCL (subject to the Scheme of Arrangement being approved and other closing conditions).

On a fully diluted basis (assuming full rights subscription), unsecured creditors would receive ~3.6bn shares (<u>~46% of total shareholdings</u>) in NCL, in exchange for a 35% haircut (the non-sustainable portion of debt). Tiong is expected to hold ~28% of NCL (down from 51.3%, assuming that he subscribes to his pro-rata share only).

D) Considering the Terms

Regarding the portion of non-sustainable debt:

It seems unlikely that the ratio of sustainable debt and non-sustainable debt will be changed. The projections provided to support the sustainable portion of debt may be ambitious, particularly given the still weak environment for NCL's core shipbuilding business. More conservative projections would actually reduce the forecasted value of NCL, resulting in even higher proportion of non-sustainable debt. Conversely, overly aggressive projections may lead to NCL not being able to support the pay down of its restructured term loan debt when it starts to amortize from the 4th year onwards.

Regarding the portion of non-sustainable debt:

Given the stark difference between the bondholder conversion price (SGD0.045 per share, more than double the last traded price) and the rights issue price (SGD0.014 per share, or 30% discount to last traded price), this would likely be the area most contentious. The FAQ had attempted to justify the price difference with the following three arguments:

"(i) The debt-to-equity conversion for the Non-Sustainable debt is for repayment of old debts which are not supported by the value of the Group (and therefore the Group is not able to repay). Instead of making the Creditors suffer an outright haircut, the Company decided to issue Non-Sustainable Debt Shares to compensate the Creditors for the Non-Sustainable Debt."

Comments: In the event that an issuer's value is unable to sustain its debts, a potential outcome is that the debt needs to be restructured, potentially receiving haircuts in order for the issuer's capital structure to be sustainable going forward. That said, by the priority of payments, any security junior to the debt impaired should be completely wiped out. Simply put, <u>debt is senior to equity</u>, if debt holders are impaired as part of the process, shareholders should receive nothing. Any deviation from this is a <u>negotiated outcome</u> between debt and shareholders. In this case, even before the rights issue, existing shareholders would retain ~37% of NCL after the issue of 3.6bn shares to bondholders rather than get wiped out despite haircuts on bondholders.

"(ii) In comparison, the Rights Issue is to raise NEW MONEY. It is offered to ALL existing Shareholders (and not only to the Major Shareholder). In addition to funding the Cash Out Option, the Company also hopes to raise funds to run its operation through these difficult times. It is therefore important that the issue price of the Rights Shares is set at a meaningful level to encourage the other Shareholders to subscribe for their entitlements under the Rights Issue."

Comments: As mentioned earlier, existing shareholders already benefit from having a surviving stake in the NCL (collectively almost 40%) despite impairments on bondholders. On top of this, shareholders are offered shares at a 30% discount to last traded price as part of the rights issue as an incentive to participate. Bondholders are unlikely to begrudge the discount given the fresh equity injection, but their own conversion price should be closer to the last traded price of SGD0.02 per share. At this price, existing shareholders would still hold ~20% of NCL (before the rights issue).

"(iii) The issuance of the Rights Shares, the Non-Sustainable Debt Shares and the Term Loan Shares are subject to approval by the existing Shareholders. The other existing Shareholders may not be supportive of such issuance of Shares and as a result they may not vote in favour of such issuance of Shares at the general meeting if they perceive the issue price of the Rights Issue is set to discourage them from taking up their entitlement."

Comments: This is a strange argument, as if the issuance of shares to bondholders is not approved by shareholders, the Scheme of Arrangement may fail, potentially driving NCL into liquidation. Given the low recoveries expected by unsecured creditors in a liquidation event, shareholders would receive zero. Comparatively, by approving the share issuance at a conversion price of SGD0.02 (versus the SGD0.045 tabled), despite providing no additional consideration, existing NCL shareholders would still collectively hold ~20% of NCL post restructuring. Furthermore, if they participate in the rights issue (with the price of SGD0.014 still superior to what bondholders had), they would collectively hold 34% of NCL on a fully diluted basis.

As such, we consider the conversion price of SGD0.045 per share for the non-sustainable portion of debt to be inequitable. That said, as mentioned earlier, deviation from the priority of payments is a negotiated outcome. Other factors should also be considered.

E) Other Factors

HoldCo-OpCo Subordination

As mentioned previously, bondholders currently face HoldCo-OpCo subordination, 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, creditors to the OpCo have to be satisfied first before any residue value can be upstream to the HoldCo for recovery by bondholders. Though NCL did provide intercompany debt (valued at USD291mn) to one of its OpCo entities (and hence have a claim), NCL had disclosed that there are other preferential claims that would have to be paid first. The Scheme of Arrangement seeks to treat all unsecured creditors (regardless of the HoldCo Notes or OpCo unsecured bank debt) equal, which benefits bondholders.

Involvement of Existing Management

A wildcard to recoveries would be the management of the outstanding vessel contracts that NCL has with its partner Chinese yards. Prior disclosures indicated USD770mn in unbilled contracted sum for these vessels. Existing management (including the majority shareholder Tiong) may be pivotal in resolving these contracts in an amicable manner. Their existing business connections, which drove NCL's prior business success, may also help NCL recover quicker (facilitated by a less encumbered balance sheet) out of its current troubles. As such, the larger stake in NCL post restructuring may help incentivize existing management.

Should the Scheme of Arrangement Fail

Though the failure in the Scheme of Arrangement going through may allow for better terms for bondholders to be negotiated (such as a better conversion price for the non-sustainable portion of debt), the risk is that the failure to pass the scheme may drive NCL to liquidation. NCL's FAQ had indicated that in a liquidation scenario, NCL estimated that unsecured creditors would receive a recovery of 6%.

F) Recommendations

In aggregate, though the terms are far from perfect, we acknowledge that NCL did improve the terms, with the conversion price reduced from SGD0.08 per share. The major shareholder Tiong is also committing MYR50mn in fresh funds into NCL. The scheme also helps mitigate the HoldCo-OpCo subordination that bondholders currently face. As such, we recommend that **bondholders support the Scheme of Arrangement**.

When considering between the Term Loan Option and the Cash Out Option for the sustainable portion of debt, it is worth considering the potential recoveries from these options.

Non-sustainable portion (35% of notional): ~11% contribution to total bond recovery given the SGD0.045 conversion price versus SGD0.014 rights share price (assuming that SGD0.014 is more reflective of fair value).

Sustainable portion (65% of notional): ~65% contribution to total bond recovery for the Term Loan Option assuming no defaults over the 7 year tenure. For the Cash Out Option, assuming an average 10% upfront cash recovery, this provides a ~6.5% contribution to total bond recovery

The above estimates are simplistic and don't consider coupon, share price movement, default risk and time value of money. With these caveats in mind, the Term Loan Option provides an estimate recovery of ~76% at the end of seven years, while the Cash Out Option offers a more immediate recovery of ~17.5% in cash and shares. Based on ultimate recoveries, it makes sense to **choose the Term Loan Option**. That said, investors should note that they are 1) bearing potential default risk over the 7 year tenure and 2) the restructured term loan may not be not tradable. There may also be potential scenarios in which bondholders may prefer to cash out for "immediate" liquidity despite the haircuts due to their own personal circumstances.