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OFFSHORE RESTRUCTURING OUTLOOK

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The first quarter of 2018 has seen the Dow and NASDAQ pushing through record highs, increasing consumer confidence in the U.S. and Europe (excluding the UK) and the January ADP jobs report, the latest at the time of writing, showed private payrolls increasing by 49,000 (26.5%) more than expected. Further, cheap credit, not only from traditional bank sources but from the private equity and hedge funds that have used their dry powder to pile into the corporate lending space, has continued, with the Alternative Credit Council and the Alternative Investment Management Association expecting private credit funds to manage in excess of $1 trillion by 2020 (up from $600 billion at the end of 2016 on the basis of Preqin data).

However, notwithstanding the above positive data, there are segments in the market that are expected to need continued restructuring work, both onshore and offshore through 2018, particularly: offshore oil and gas drillers; European and U.S. retail; and the highly leveraged Chinese real estate sector.

Energy Restructuring

Two key issues exist for the offshore oil and gas drillers: 1) the price of oil; and 2) the continuing oversupply of rigs in the market. Both will feed into the number of new drilling contracts being awarded, as well as the day-rates achievable for such contracts.

As shown in the graph above, the price of oil increased at the start of 2018 and, in January 2018, crossed $70 a barrel for the first time since Dec. 2, 2014. This has been driven primarily by OPEC/Non-OPEC compliance with agreed production cuts and the collapse in Venezuelan output, which drove OPEC compliance to 129% in December 2017. With the OPEC/Non-OPEC deal currently in place until the end of 2018 and problems in Venezuela expected to continue, there are prima facie reasons to expect a supply-side driven rebalancing in the market, as shown in the IEA's Demand/Supply diagram below.

However, notwithstanding these supply-side factors, while there are some commentators who expect a breakout in the oil price in 2018, I expect oil to generally remain range-bound between $60 and $70, with occasional upside swings due to short-term supply issues, as was seen in late 2017 with the crack in the Forties

Pipeline and the explosion at a Libyan pipeline, which cut 70,000 – 100,000 bpd from Libyan production. The main reasons for this are the increasing short-cycle production in the U.S., where U.S. rigs are able to react quickly to increasing oil prices and come back online, as shown by Baker Hughes' +235 U.S. rig count change from Jan. 27, 2017 to Jan. 19, 2018, and the oil price hedging, which onshore producers have entered into during the recent oil price rally that will allow them to pump oil profitably throughout the lifetime of the hedge.

Given this oil price expectation, there is unlikely to be significant growth in the number of drilling contracts being awarded, notwithstanding that there have been signs of the start of a recovery in the harsh environment sector (particularly the semi-sub harsh environment sector, as shown by the recent acquisition of the Stena MidMAX for a reported $500 million). Further, where new contracts are awarded, the day-rates achievable will be minimal due to the competition for contracts as companies look to put their warm and cold-stacked rigs to work and the contracts may be long-dated as oil producers try and lock in low day-rates for 2019 and beyond.

On this basis, I expect to see a bifurcation in the market between: 1) companies whose fleet consists of primarily later generation drilling rigs, which will be favored by oil producers who may be able to contract such rigs at low day-rates; and 2) companies with older generation warm and cold-stacked rigs as such older rigs will struggle to compete for contracts with the newer generation rigs and may end up never returning to the market. Those companies who fall within the later will be prime restructuring candidates.

A further interesting dynamic that will start to play-out in 2018 is the impact of previously restructured companies. In 2017, Ocean Rig successfully restructured its debt by way of multiple Cayman schemes of arrangement. Pacific Drilling and SeaDrill are currently undertaking restructurings by way of Chapter 11 — with right-sized balance sheets and no/limited debt service costs, these companies should be able to undercut their competitors for new contracts, potentially forcing financially stronger companies to restructure their own debt simply so that they can compete for work (as was previously seen in the U.S. aviation industry).

Therefore, the ability of offshore drillers to avoid restructuring will primarily depend on their existing backlog and debt maturity profiles rather than cash flow from new contracts this year. On the basis of this analysis, there are three or four offshore drillers who are currently obvious restructuring candidates, including one company that currently has all of its rigs, warm or cold, stacked, and a maturity schedule that includes large repayments due in 2019.

Further candidates are likely to be added to this list throughout 2018 as rigs roll off existing contracts and, as expected, extension options fail to be exercised. As such, there is an expectation that we will see continued restructuring work from the offshore drilling sector in the next 12 months, although it will remain to be seen whether this will be through an offshore driven Ocean Rig style restructuring or through the use of Chapter 11.

In addition, or potentially as an alternative, there will be a continuation of M&A in the offshore drilling sector. 2017 saw a number of strategic acquisitions being implemented, including Ensco's acquisition of Atwood, the acquisition of Songa by Transocean, and the acquisition by Borr Drilling of Transocean's jack-up fleet. It can be expected that further M&A will occur throughout 2018, with a number of offshore drillers expected to be interested in strategic distressed acquisitions in order to acquire increased backlog and assets at a distressed price.

Retail

The first quarter of 2018 has been another difficult one for retail, following 2017 which saw almost 7,000 store closure announcements in the United States, according to a tracker from FGRT. This trend of closures is expected to continue throughout 2018 as companies readjust their brick and mortar operations in light of the continued increase in online shopping, although this may be curtailed in the U.S. to some extent by the recent Teavana ruling in which Simon Property Group managed to prevent Starbucks from closing 77 of its Teavana stores.

However, the financial distress in U.S. retail has not fed through into an increase in offshore restructuring work, as restructurings in this sector are undertaken onshore. This is true even for those companies with an offshore holding structure, as can be seen in the Chapter 11 restructuring of Gymboree, which had its ultimate holding company in Cayman. As such, the continued distress in U.S. retail is unlikely to contribute to the offshore restructuring workload.

The restructuring of UK retail on the other hand provides an opportunity for offshore restructuring lawyers to provide assistance in three key scenarios: 1) the group includes an offshore holding company; 2) the group includes an offshore financing company; or 3) the restructuring will consist of the creation of a new offshore, predominantly Jersey, holding structure and the transfer of assets into the new structure.

In fact, 2018 has already seen significant credits in the market that involve such scenarios including Carillion (although not retail, this is a good example of where offshore finance company issues can arise), whose structure included a number of Jersey and Isle of Man entities, including a Jersey issuer of convertible notes and the fashion chain New Look, which has a Jersey holding structure.

Looking at the reasons for distress in this sector, a number of significant challenges have affected UK retail in the past 12 months, including an increase in the statutory minimum wage, increasing business rates and the continued impact of the 2016 Brexit vote, which reduced consumer confidence and devalued GBP, increasing input costs for many UK businesses.

Further headwinds include: declining consumer confidence/consumer spending as high inflation and wage stagnation squeeze real disposable income; increased input costs as the pound remains devalued against the USD and currencies pegged to the USD potentially devalue further as Brexit negotiations continue; and continued movement from in-store to online sales, hitting those retailers with a large brick and mortar presence expected to continue through the remainder of 2018, driving the need for further restructuring.

In addition, the General Data Protection Regulation (GDPR) will come into effect in May 2018, which will impose additional data protection rules and increase potential fines for non-compliance from their current levels to up to €20M or 4% of turnover. In July 2017, research from Compuware showed that 77% of retailers did not have a GPDR strategy in place, and less than 50% were well-briefed on the potential impact of GPDR. As such, there may be a substantial impact in the coming months as retailers spend significant amounts preparing for these changes in data protection laws or risk fines and reputational risk for breaching the new laws.

Given these issues and the continued Brexit uncertainty, 2018 is expected to be a very challenging year for UK retailers and significant UK retail restructuring can be expected. While the majority of these restructurings may not involve an offshore element, a number can be expected to include (or at least consider) the transfer of assets/the business into a new offshore holding structure or dealing with debt at an offshore finance company and will therefore drive work for offshore firms, particularly in Jersey.

Hong Kong and China

At this time, restructuring professionals are still not seeing the flow of work that has been predicted for a number of years based on Chinese NPL and "Special Mention" loan statistics, with such loans totaling around RMB ¥4 trillion (or U.S. $628 billion) based on 2016 data. This is in part due to the continuation of cheap credit as well as the work by President Xi Jinping's administration to use the mixed ownership reform program to deal with some of the most indebted SOEs.

One notable case that deserves mention is the restructuring plan of Dongbei Special Steel Group Co. Ltd., which was approved by the Dalian Intermediate People's Court and consisted of the first debt for equity swap in relation to publicly issued bonds that were in default. While not an offshore matter, interest will be taken in whether this structure is used more frequently going forward.

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While some commentators are now predicting late 2018 as the time when more restructuring work flows from China and Hong Kong, there is limited data to support this. There will certainly be some additional pressure points on companies with USD denominated debt as interest rates rise, primarily driven by the expected movement in the USD/Yuan peg as capital flows back to the U.S., but the Fed's proposed path of interest rate rises, as shown by its December 2017 dot plot (the latest available at the time of writing), shown below, is unlikely to be sufficient to force a significant increase in restructuring work. This is true notwithstanding the slightly more hawkish Powell replacing Yellen as chairman of the Fed and the January 2018 FOMC statement, which referenced increasing inflation in the U.S.

Further, while China's GDP growth rate has slowed to 6.7% (or lower if you look at other indicators such as rail traffic, electricity consumption and coal consumption), the economy is unlikely to slow to such an extent that widespread debt restructuring would be required.

Notwithstanding the above, there are sectors that are more prone to restructuring need. One of these is the highly leveraged real estate sector, where firms have approximately $63 billion of USD denominated debt but have FX assets cover of less than 25%. When you add to this the traditional reluctance of Chinese firms to hedge against currency risks, due to the expectation that the cost of hedging would be more costly than the protection provided in light of the USD peg, this is certainly one sector which could be hard hit by FX movements as U.S. interest rates rise.

In addition, it will be necessary to continue to follow U.S./China relations, particularly in light of the continued threat of further tariffs being imposed by the U.S. on Chinese imports, and the expansion of those already in place (such as the imposition of heavy taxes on steel imports from Vietnam as the U.S. believes China is using Vietnam to avoid penalties).

Finally, restructuring work can be expected on an ad hoc basis as accounting issues come to light, primarily in PRC companies where there has traditionally been less stringent regulation, as seen in the ongoing Huishan Dairy matter.

Overall, offshore restructuring lawyers will continue to monitor the financial situation in Hong Kong and China very closely in Q2 – Q4 of 2018. With over 40% of Hong Kong listed companies being incorporated in Cayman, and a large number in BVI and Bermuda, there will certainly be a need for offshore restructuring advice, particularly in certain over-levered sectors as interest rates rise. However, the traditional issues of implementation and enforcement in PRC may limit the scope for offshore restructuring solutions to be used. Further, the new threat to the use of traditional offshore solutions from Singapore's new insolvency legislation, which includes, among other things, rescue (DIP) financing and aims to turn Singapore into a restructuring hub as well as an arbitration hub, may further limit the role of the traditional offshore jurisdictions.

Conclusion

At the time of writing, there are strong indications that offshore restructuring teams will continue to be busy throughout 2018, both on offshore driven restructurings and providing assistance to onshore counsel for Chapter 11 and UK scheme/administration processes.

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