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Offshore Restructuring Review and Outlook

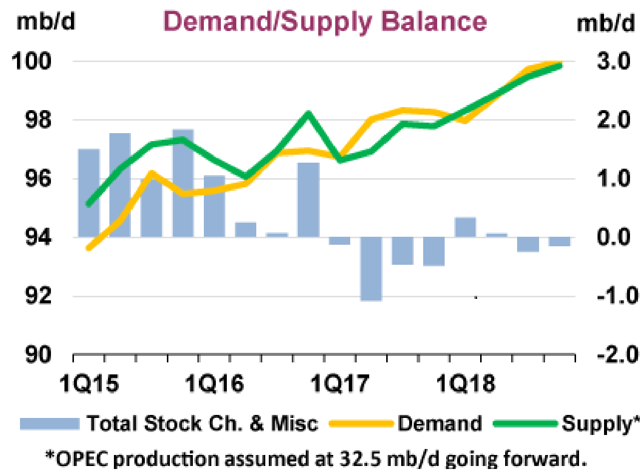
With 2017 having drawn to a close, it makes sense to look back briefly at the work which has driven the offshore restructuring world in the past year. More importantly, it is time to consider the restructuring trends that may be seen in the next twelve months in light of factors including: (i) a rising interest rate environment in the US; (ii) continued coordinated OPEC / non-OPEC action; and (iii) ongoing disruption in traditional bricks and mortar retail.

Energy Restructuring

The ongoing distress in the energy sector, particularly in the offshore services and drilling sector, has been the main source of restructuring work for Caribbean and Bermuda offices this year – in the Cayman Islands (**Cayman**) the restructurings of Ocean Rig and CHC dominated whilst in the British Virgin Islands and Bermuda significant mandates have included the ongoing Chapter 11s of Pacific Drilling and Seadrill. Ocean Rig was a particularly significant restructuring for Cayman as it involved four inter-conditional Cayman schemes of arrangement relating to one company which had been continued into Cayman from the Marshall Islands and three Marshall Islands incorporated companies which were subject to a COMI shift to create the necessary jurisdiction. As such, it has been hailed as a potential template for future offshore restructurings where parties wish to avoid the traditional Chapter 11 restructuring option.

The causes of distress in 2017 for the offshore drilling sector, including low oil prices and the oversupply of existing and new rigs which have driven cancelled contracts and the renegotiation of day rates to at or below break-even, have been discussed at length in other articles and so will not be covered here. The key question is whether such factors will continue to drive restructurings in 2018.

While moves by OPEC and non-OPEC nations have limited supply and created a partial rebalancing of the market, driving an increase in oil price in the second half of 2017, as shown in the diagrams below, oil continues to remain below the threshold required for a significant increase in offshore drilling contracts, particularly in the UDW sector.



Source: IEA Oil Market Report 14 Dec 2017

Price of Brent Jan – Dec 2017 Source: Bloomberg

While there are some commentators who expect a break-out in the oil price in 2018, oil is more likely to generally remain range-bound between USD 60 and USD 70, with occasional upside swings due to short-term supply issues, as has been seen recently with the crack in the Forties Pipeline and the explosion at a Libyan pipeline which has cut 70,000 – 100,000 bpd from Libyan production. This baseline takes into account a number of factors including the clear ability of US rigs to quickly come back online, as shown by the Baker Hughes rig count and the +278 increase in US rigs between 23 December 2016 and 15 December 2017 and the potential increase in oil production in Libya and Nigeria, who are not caught by the OPEC / non-OPEC agreement.

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 with new contracts being awarded including the new thirty-three month Statoil contract which Transocean recently won at a day rate of USD 295,000. Therefore, the ability of offshore companies to avoid restructuring will primarily depend on their existing backlog and debt maturity profiles rather than cashflow from new contracts this year. On the basis of this analysis there are three, possibly four, offshore drillers who are currently obvious restructuring candidates, including one company which currently has all of its rigs warm or cold stacked and a maturity schedule which 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, we expect to 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 US Chapter 11.

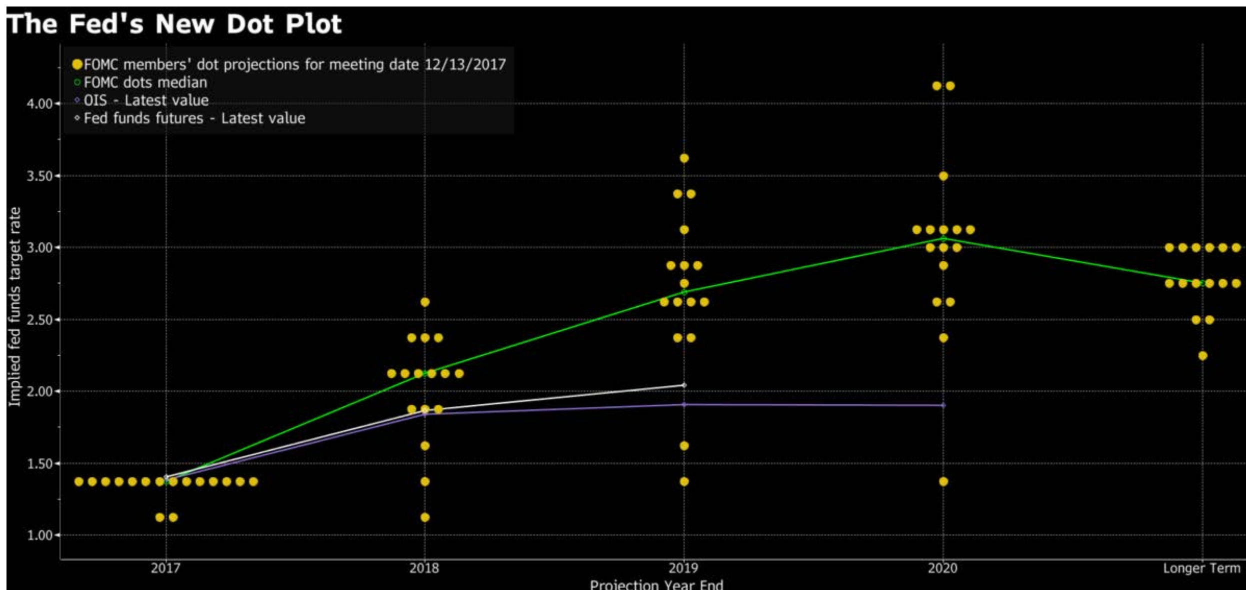
In addition, or potentially as an alternative, there will be a continuation of M&A in the offshore drilling sector. 2017 saw a number of strategic acquisitions being implemented, including Ensco's acquisition of Atwood, the acquisition of Songa by Transocean and the acquisition by Borr Drilling of Transocean's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

Hong Kong and China

There was limited offshore restructuring work out of Hong Kong and China in 2017. While there were some notable cases, restructuring professionals are still not seeing the flow of work which has been predicted for a number of years based on NPL and "Special Mention" loan statistics, with such loans totaling around RMB ¥4 trillion (or USD $628 billion) based on 2016 data. This is in part due to the continued cheap credit which was available throughout 2017 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 which does, however, deserve 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 which were in default. While not an offshore matter, interest will be taken in whether this structure is used more frequently going forwards.

While some commentators are now predicting 2018 as the year in which 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 US, but the FED's proposed path of interest rate rises, as shown by their dot plot, below, is unlikely to be sufficient to force a significant increase in restructuring work.



Federal Open Market Committee Dot Plot – Dec 2017 – Source: Bloomberg

Further, while China's GDP growth rate has slowed to 6.7% (or lower if one looks 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 of course sectors which are more prone to restructuring need – one sector I continue to monitor is the highly leveraged real estate sector where firms have approximately USD 63 billion of USD denominated debt but have FX assets cover of less than 25%. When one adds to this the traditional reluctance of Chinese firms to hedge against currency risks, due to 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 US interest rates rise. In addition, it will be necessary to continue to follow US/China relations particularly in light of the continued threat of further tariffs being imposed by the US 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 US believe 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 recently in the ongoing Huishan Dairy matter.

Overall, 2018 should be an interesting year for offshore restructuring lawyers when looking at Hong Kong and China - 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 and the new threat to the use of traditional offshore solutions from Singapore's new insolvency legislation, which includes amongst 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.

Retail

2017 has seen almost 7,000 store closures in the United States announcements according to a tracker from FGRT, nearly double the amount seen in 2016. This trend of closures is expected to extend into 2018 as companies re-adjust their bricks and mortar operations in light of the continued increase in online shopping, although this may be curtailed in the US 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 US 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 US retail in 2018 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 assist due to the increasingly common use of offshore, predominantly Jersey, newco(s) as the new holding structure for entities which have been restructured by way of UK administration or UK scheme of arrangement.

A number of significant headwinds affected UK retail in 2017, 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. Looking forward to 2018, similar headwinds will continue and drive the need for further restructuring including: (i) declining consumer confidence / consumer spending as high inflation and wage stagnation squeeze real disposable income; (ii) increased input costs as the pound remains devalued against the USD and currencies pegged to the USD and potentially devalues further as Brexit negotiations continue; and (iii) continued movement from instore to online sales, hitting those retailers with a large bricks and mortar presence. One additional headwind which may affect retailers is the coming into effect of the General Data Protection Regulation in May 2018 which will impose additional data protection rules and increase potential fines for non-compliance from their current levels to up to EUR 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 significant headwinds 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 will not involve an offshore element, a number can be expected to include / consider the transfer of assets / the business into a new offshore holding structure and will therefore drive work for offshore firms, particularly in Jersey.

Conclusion

2017 was an extremely busy year for offshore restructuring practitioners, particularly in Cayman and Bermuda, where large and complex energy restructurings kept teams busy throughout the year. While there was a slow-down in such work towards the end of the year, 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.

Given this expectation, in all cases where a corporate structure includes an offshore holding company, or finco or the restructuring may involve an offshore process or the creation of an offshore holding structure we advise clients and onshore advisors to reach out at an early stage in the process so that all options may be fully discussed and considered in the planning phase of the restructuring process.

Appleby has significant off-the-shelf offshore restructuring know-how and we would be delighted to provide and discuss in more detail any queries you may have.

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David Bulley joined Appleby in August 2015 from Sullivan & Cromwell in London and leads the Cayman corporate restructuring team. David's practice involves both debtor and creditor representations and his representations in Cayman have included acting for CHC on the Cayman aspects of its Chapter 11 and for the ad hoc group of senior creditors in the restructuring of Ocean Rig UDW Inc. by way of four inter-connected schemes of arrangement, with Appleby being the only firm to act in a lead capacity on both of these restructurings. David is also heavily involved in Norwegian bond restructurings, acting for the Nordic Trustee on Cayman aspects of such matters.

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